No. 23-15825

IN THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

In the Matter of: MICHAEL A. LEITE; ANDREA C. CARVALHO,
Debtors,

UNITED STATES OF AMERICA,
Appellant,

v.

ROBERT A. MACKENZIE, Chapter 7 Trustee,

Appellee.

ON APPEAL FROM THE JUDGMENT OF THE UNITED STATES DISTRICT COURT FOR THE DISTRICT OF ARIZONA

BRIEF FOR THE APPELLANT

DAVID A. HUBBERT
Deputy Assistant Attorney General

BRUCE R. ELLISEN (202) 514-2929
MATTHEW S. JOHNSHOY (202) 616-1908
Attorneys
Tax Division
Department of Justice
Post Office Box 502
Washington, D.C. 20044

Of Counsel:
GARY M. RESTAINO
United States Attorney

TABLE OF CONTENTS

Page

Table of contents i
Table of authorities iv
Glossary x
Statement of jurisdiction 1
Statement of the issue 4
Applicable statutes and regulations 4
Statement of the case 4

A. Procedural background 4

B. Legal framework 5

1. Tax liabilities and tax liens 5

2. The Bankruptcy Code lien avoidance and preservation provisions at issue 6

C. Factual background 10

D. This adversary proceeding and the opinions below 11

1. Summary judgment proceedings 12

2. The Bankruptcy Court's first opinion 13

3. The District Court's first opinion 15

4. The Bankruptcy Court's second opinion 17

5. The District Court's second opinion 18

Summary of argument 18
Argument 21

Page

Proceeds from the sale of property should be allocated first to the tax portion of a tax lien before any proceeds are allocated to the avoided penalty portion of the lien 21

Standard of review 21

A. Introduction.. 22

B. Allocating proceeds first to the tax portion of a tax lien is the only approach that both interprets § 724(a) in a way that is consistent with long established bankruptcy law and practice and respects the fundamental bankruptcy principle that secured creditors must be paid first from their collateral 23

1. The statutory and legislative history support interpreting § 724(a) in a way that ensures that the tax portion of a tax lien is paid first 24

i. The history and purpose of § 724(a) 25

ii. The history and purpose of § 551............... 29

iii. The avoidance of noncompensatory penalties under § 724(a) was merely intended to prevent the estate from being diminished by penalties, it was not meant to create a windfall for unsecured creditors as the pro rata approach does 31

2. It is a fundamental bankruptcy principle that the interests of secured creditors in their collateral are protected, and thus, that secured creditors are entitled to be paid first 37

Page

C. The contrary reasoning of the courts below is unpersuasive 42

1. The District Court improperly relied on 11 U.S.C. § 105 to adopt a pro rata approach that violates § 724(a)—as can be seen after § 724(a) is properly interpreted based on pre-Code practice 42

2. Equality of treatment for equal creditors is the norm, but this case does not involve that principle since the tax and penalty portions of a tax lien are not on equal footing 46

3. The fact that here the penalty portion of the tax lien happens to be out of the money should not be allowed to obscure the fact that lien avoidance under § 724(a) will still often benefit the estate even after a tax first allocation 49

Conclusion 53
Addendum 54
Statement of related cases 71
Certificate of compliance 72

Case: 23-15825, 10/02/2023, ID: 12802421, DktEntry: 11, Page 5 of 83

TABLE OF AUTHORITIES

Cases: **Page(s)**

Ad Hoc Comm. of Holders of Trade Claims v. Pac. Gas and Elec. Co. (*In re PG&E Corp.*), 46 F.4th 1047 (9th Cir. 2022) 25, 29

Battley v. United States (*In re Berg*), 121 F.3d 535 (9th Cir. 1997) 22, 35

Begier v. IRS, 496 U.S. 53 (1990) 46

Bruning v. United States, 376 U.S. 358 (1964) 11

Bull v. United States, 295 U.S. 247 (1935) 35

Cohen v. de la Cruz, 523 U.S. 213 (1998) 25

Czyzewski v. Jevic Holding Corp., 580 U.S. 451 (2017) 38, 39, 41, 47

Decker v. Tramiel (*In re JTS Corp.*), 617 F.3d 1102 (9th Cir. 2010) 21, 22

DeMarah v. United States (*In re DeMarah*), 62 F.3d 1248 (9th Cir. 1995) 8, 31

Dewsnup v. Timm, 502 U.S. 410 (1992) 24, 25, 38

Emil v. Hanley, 318 U.S. 515 (1943) 24

In re Fesco Plastics Corp., 996 F.2d 152 (7th Cir. 1993) 43

Gill v. Kirresh (*In re Gill*), 574 B.R. 709 (B.A.P. 9th Cir. 2017) 31

Gugliuzza v. FTC (*In re Gugliuzza*), 852 F.3d 884 (9th Cir. 2017) 3

Hartford Underwriters Ins. Co. v. Union Planters Bank, N.A., 530 U.S. 1 (2000) 38, 39

Hutchinson v. United States, Dep't of Treasury, IRS (*In re Hutchinson*), 15 F.4th 1229 (9th Cir. 2021) 9, 36

Cases (continued): **Page(s)**

In re Hutchinson,
No. 17-bk-12272, 2022 WL 1021843
(Bankr. E.D. Cal. Apr. 1, 2022),
appeal pending, No. EC-22-1078 (B.A.P. 9th Cir.) 36, 50

IRS v. Baldiga (*In re Hannon*),
619 B.R. 524 (D. Mass. 2020) 32

Johnson v. Home State Bank,
501 U.S. 78 (1991) 43

Law v. Siegel,
571 U.S. 415 (2014) 43

Leichty v. Neary (*In re Strand*),
375 F.3d 854 (9th Cir. 2004) 22

N. Slope Borough v. Barstow (*In re MarkAir, Inc.*),
308 F.3d 1057 (9th Cir. 2002) 51

Norwest Bank Worthington v. Ahlers,
485 U.S. 197 (1988) 43

Pac. Gas & Elec. Co. v. California,
350 F.3d 932, 943 (9th Cir. 2003) 25

Retail Clerks Welfare Trust v. McCarty (*In re Van de Kamp's Dutch Bakeries*),
908 F.2d 517 (9th Cir. 1990) 9, 29, 30

Samson v. Western Capital Partners, LLC
(*In re Blixseth*), 684 F.3d 865 (9th Cir. 2012) 7

Saslow v. Andrew (*In re Loretto Winery Ltd.*),
898 F.2d 715 (9th Cir. 1990) 22

Saxman v. Educ. Credit Mgmt. Corp. (*In re Saxman*),
325 F.3d 1168 (9th Cir. 2003) 43

In re Seneca Balance, Inc.,
114 B.R. 378 (Bankr. W.D.N.Y. 1990) 48, 49

Seror v. Kahan (*In re Kahan*),
28 F.3d 79 (9th Cir. 1994) 7

Simonson v. Granquist,
369 U.S. 38 (1962) 26, 27, 29, 48

Cases (continued): **Page(s)**

In re Specialty Cartage, Inc.,
115 B.R. 164,166-67 (Bankr. N.D. Ind. 1989),
aff'd sub nom., United States v. Specialty Cartage, Inc.,
113 B.R. 484 (N.D. Ind. 1990) 49

State Bd. of Equalization v. Stodd (*In re P.R.O. Enters., Inc.*), 500 F.2d 1208 (9th Cir. 1974) 26

State of Wash., Emp. Sec. Dep't v. Hovan, Inc. (*In re Hovan, Inc.*),
96 F.3d 1254 (9th Cir. 1996) 8

Towers v. United States (*In re Pac.-Atl. Trading Co.*),
64 F.3d 1292 (9th Cir. 1995) 48

U.S. Dep't of Interior v. Elliott,
761 F.2d 168 (4th Cir. 1985) 8

United States v. Darnell (*In re Darnell*),
834 F.2d 1263 (6th Cir. 1987) 37

United States v. Ledlin (*In re Mark Anthony Constr., Inc.*),
886 F.2d 1101 (9th Cir. 1989) 11

United States v. Mackenzie,
No. 21-16987 (9th Cir. Jan. 6, 2022) 3

United States v. Martin (*In re Martin*),
542 B.R. 479 (B.AP. 9th Cir. 2015) 48

United States v. Warfield (*In re Freeman*),
2023 WL 2665735 (D. Ariz. Mar. 28, 2023), *appeal pending*, No. 23-15827 (9th Cir.) 24

United States v. Warfield (*In re Tillman*),
53 F.4th 1160 (9th Cir. 2022) 9

Statutes:

Bankruptcy Act of 1898 (Former 11 U.S.C.):
§ 93(e) (1976 ed.) (Bankruptcy Act § 57e) 37
§ 93(j) (1976 ed.) (Bankruptcy Act Section 57j) 19, 25-28, 31
§ 107(c)(4) (1976 ed.) (Bankruptcy Act § 67c(4)) 31

Bankruptcy Code (11 U.S.C.):
§ 101(54)(A) 9

Statutes (continued): **Page(s)**

Bankruptcy Code (11 U.S.C.) (cont'd):
§ 105 42
§ 105(a) 16, 20, 42, 43, 44, 45
§ 361 .... 39, 40
§ 363 .... 39, 40
§ 363(e) 40
§ 506(b) 40
§ 507 46
§ 507(a)(1)(C) 12, 51
§ 507(a)(2) 12, 51
§ 522 7
§ 541 7
§ 541(a) 6
§ 541(a)(1) 7
§ 541(a)(2) 7
§ 541(a)(3) 7
§ 541(a)(4) 7, 9
§ 541(a)(5) 7
§ 541(a)(6) 7
§ 541(a)(7) 7
§ 544(a)(1) 6
§ 550 7
§ 551 .... 7, 9, 11, 12, 16, 24, 29, 30, 31, 40, 50
§ 552 40
§ 553 40
§ 554 40
§ 554(a)(1) 7
§ 724 19
§ 724(a) 2, 4, 7-9, 11-12, 18-20, 22-25, 28-29, 31-32, 34, 36, 40-42, 44-47, 49, 52
§ 724(b) 12-16, 51-52
§ 724(e)(1) 51
§ 725 .... 19-20, 38-39, 44, 47-48
§ 726 .... 7, 11, 39, 46-47
§ 726(a)(2) 28
§ 726(a)(3) 28

Statutes (continued): **Page(s)**

Bankruptcy Code (11 U.S.C.) (cont'd):
§ 726(a)(4) 7, 28, 36
§ 726(a)(6) 28
§ 726(b) 46
§ 1129(b)(2)(A) 39
§ 1225(a)(5) 39
§ 1325(a)(5) 39

Internal Revenue Code (26 U.S.C.):
§ 1 5
§ 61 5
§ 6012 5
§ 6151 5
§ 6201 5
§ 6215 5
§ 6321 .... 5, 6, 35
§ 6322 6
§ 6323(a) 6
§ 6402(a) 15
§ 6601 5
§ 6651(a) 5, 48

28 U.S.C.:
§ 157(b) 2
§ 158(a) 3
§ 158(d) 3
§ 1334(b) 2

Other Authorities:

11 U.S.C.A Disposition Table (West 2023) 26

9th Cir. R. 28-2.7 4

2 *Collier on Bankruptcy* ¶ 105.01 (16th ed. 2023) 42

Other Authorities (continued): **Page(s)**

4 *Collier on Bankruptcy* ¶ 506.02 (16th ed. 2023) 37

5 *Collier on Bankruptcy* ¶ 551.02 (16th ed. 2023) 9

6 *Collier on Bankruptcy* ¶ 725.01 (16th ed. 2023) 39

Fed. R. App. P.:
Rule 4(a)(1) 3
Rule 6(b) 3
Rule 28(f) 4

H.R. Rep. No. 95-585 (1977),
reprinted in 1978 U.S.C.C.A.N. 5963 .... 8-10, 25, 27, 30, 38, 50

John C. Chobot, *Preserving Liens Avoided in Bankruptcy—*
Limitations and Applications,
62 Am. Bankr. L.J. 149 (1988) 29

S. Rep. No. 95-989 (1978),
reprinted in 1978 U.S.S.C.A.N. 5787 .... 8, 25, 28, 31

U.S. Const. amend. V, cl. 4
(the Takings Clause) 38

GLOSSARY

1st App. Doc.	Numbered docket entries in D. Ct. No. 2:20-cv-02200-DWL (D. Ariz.)
Adv. Doc.	Numbered docket entries in Bankr. Adv. No. 2:20-ap-00124-BKM (Bankr. D. Ariz.)
Bankruptcy Act	Bankruptcy Act of 1898 (as amended) (former 11 U.S.C.)
Bankruptcy Court	United States Bankruptcy Court for the District of Arizona
Bankr. Doc.	Numbered docket entries in Bankr. No. 2:19-bk-12205-BKM (Bankr. D. Ariz.)
Code	Bankruptcy Code (11 U.S.C.)
Debtors	Michael A. Leite and Andrea C. Carvalho
District Court	United States District Court for the District of Arizona
ER	Excerpts of record
Government	United States of America, appellant
I.R.C.	Internal Revenue Code (26 U.S.C.)
IRS	Internal Revenue Service
The Property	The home owned by the debtors when they filed bankruptcy
Trustee	Robert A. Mackenzie, appellee

IN THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

No. 23-15285

In the Matter of: MICHAEL A. LEITE; ANDREA C. CARVALHO,
Debtors,

UNITED STATES OF AMERICA,

Appellant,

v.

LAWRENCE J. WARFIELD, Chapter 7 Trustee,

Appellee.

ON APPEAL FROM THE JUDGMENT OF THE UNITED STATES DISTRICT COURT FOR THE DISTRICT OF ARIZONA

BRIEF FOR THE APPELLANT

STATEMENT OF JURISDICTION

In September 2019, Michael A. Leite and Andrea C. Carvalho ("the debtors") filed a Chapter 7 bankruptcy petition in the United States Bankruptcy Court for the District of Arizona.[1] (Bankr. Doc. 1.)

---

[1] Unless otherwise indicated, statutory references are to the Bankruptcy Code (11 U.S.C.). "I.R.C." references are to the Internal Revenue Code (26 U.S.C.). "Bankr. Doc." references are to documents in the record from the main case in the Bankruptcy Court. "Adv. Doc.

(continued…)

Robert A. Mackenzie, the Chapter 7 trustee ("the trustee"), filed an adversary proceeding seeking to avoid the penalty portion of the federal tax lien for tax year 2009 pursuant to Bankruptcy Code § 724(a) (11 U.S.C.) ("the Code") and then allocate the proceeds between the IRS and the estate, as well as other related relief. (ER-129–136.)

The Bankruptcy Court had jurisdiction under 28 U.S.C. §§ 157(b) and 1334(b). The Bankruptcy Court (Judge Martin) entered an order ruling that the trustee could avoid the penalty portion of the tax lien and allocating the lien proceeds. (ER-63–65.) The court denied the Government's motion (Adv. Doc. 40) to alter or amend the order. (ER-59–62.)

The United States appealed. (ER-159–161.) The District Court (Judge Lanza) entered an order and a judgment affirming in part, reversing in part, and remanding for further proceedings. (ER-34–58.)

The United States filed a protective notice of appeal. (ER-153–158.) This Court later granted the Government's unopposed motion to

---

references are to documents in the Bankruptcy Court record for this adversary proceeding. "1st App. Doc." references are to the documents in the first District Court appeal record. "ER" references are to the appellant's excerpts of record.

dismiss the appeal for lack of jurisdiction. *United States v. Mackenzie*, No. 21-16987 (9th Cir. Jan. 6, 2022); *see Gugliuzza v. FTC* (*In re Gugliuzza*), 852 F.3d 884, 899 (9th Cir. 2017) (a district court ruling that remands a case to the bankruptcy court for further proceedings that are more than mechanical or computational is not a final, appealable order under 28 U.S.C. § 158(d)).

On remand, the Bankruptcy Court entered a new final order resolving all of the issues. (ER-31–33 (entered March 10, 2022).)

On March 23, 2022, the United States filed a timely notice of appeal. (ER-147–152.) The trustee also filed a timely notice of appeal on April 5, 2022. (ER-140–146.) The District Court had jurisdiction under 28 U.S.C. § 158(a). On March 30, 2023, the District Court (Judge Lanza) entered an order and opinion affirming the order of the Bankruptcy Court. (ER-6–24.) That same day, the District Court entered judgment. (ER-5.)

On May 24, 2023, the United States filed a timely notice of appeal. (ER-137–139.) *See* Fed. R. App. 4(a)(1) and 6(b). This Court has jurisdiction under 28 U.S.C. §§ 158(d), 1291.

STATEMENT OF THE ISSUE

This case concerns the allocation of proceeds from the sale of real property subject to a tax lien that was partially avoided under 11 U.S.C. § 724(a).

The issue presented is whether, following avoidance of a penalty lien under § 724(a), the sale proceeds should be allocated pro rata between the IRS and the estate based on the relative amounts of the tax and penalty portions of the lien, or whether the proceeds should be allocated first to the unavoided tax portion of the lien and then second to the penalty portion of the lien.

APPLICABLE STATUTES AND REGULATIONS

The relevant statutes are included in the Addendum, *infra*. *See* Fed. R. App. P. 28(f); 9th Cir. R. 28-2.7.

STATEMENT OF THE CASE

A. Procedural background

The Bankruptcy Court held that the trustee could avoid the penalty portion of an IRS tax lien using § 724(a) and that the proceeds from the sale of property would then be allocated between the tax and penalty portions of the lien pro rata. (ER-59–65.) The District Court agreed, but remanded for further proceedings in the Bankruptcy Court

on another issue that affected the allocation amounts. (ER-34–58.) On remand, the Bankruptcy Court decided that issue and entered a new order that the proceeds would be allocated between the tax and penalty portions of the tax lien. (ER-25–33, ER-66–80.) The District Court affirmed. (ER-5–24.) This appeal follows.

B. Legal framework

1. Tax liabilities and tax liens

The Internal Revenue Code imposes an income tax and generally requires that all individuals file income tax returns and pay all income tax owed. I.R.C. §§ 1, 61, 6012, 6151. Any taxpayer who fails to timely file a proper return, fails to timely pay the tax owed, or fails to comply with certain other requirements may then incur penalties. *See* I.R.C. § 6651(a). Interest accrues on both tax and penalties. I.R.C. § 6601.

To collect the amounts owed, the IRS may assess the liabilities by making a bookkeeping entry formally recording the liability. I.R.C. §§ 6201, 6215. If a taxpayer does not pay the tax owed after a demand for payment is sent, then a tax lien arises "in favor of the United States upon all property and rights to property . . . belonging to such person." I.R.C. § 6321.

This tax lien "arise[s] at the time the assessment is made" and continues "until the liability . . . is satisfied or becomes unenforceable by reason of lapse of time." I.R.C. § 6322. The lien covers both the assessed tax and "any interest, additional amount, addition to tax, or assessable penalty, together with any costs that may accrue in addition thereto." I.R.C. § 6321. While the lien is immediately valid against the taxpayer, I.R.C. § 6323(a) provides that the lien is "not valid" against certain other third parties (such as "any purchaser, holder of a security interest, mechanic's lienor, or judgment lien creditor") until a public notice of the tax lien is filed. Thus, the date that the notice of federal tax lien is filed is relevant to determining whether a federal tax lien is superior to competing interests in the taxpayer's property. If the IRS does not file a notice of lien with respect to a particular lien, then that lien would not be treated as a secured claim in bankruptcy. *See* 11 U.S.C. § 544(a)(1) (a bankruptcy trustee has the rights of a judgment lien creditor as of the commencement of the bankruptcy case).

2. The Bankruptcy Code lien avoidance and preservation provisions at issue

After a bankruptcy petition is filed, a bankruptcy estate is formed. 11 U.S.C. § 541(a). In an individual bankruptcy, the estate consists of

the property brought into the estate under § 541 minus any property removed through exemptions under § 522. *See Seror v. Kahan* (*In re Kahan*), 28 F.3d 79, 81 (9th Cir. 1994). Section 541 lists property that becomes estate property as of the commencement of a bankruptcy case, and also provides that a trustee may increase the property of the estate through the various transfer and lien avoidance provisions in the Code. *See* 11 U.S.C. § 541(a)(1)-(7); *Samson v. Western Capital Partners, LLC* (*In re Blixseth*), 684 F.3d 865, 871 (9th Cir. 2012); *see also* 11 U.S.C. §§ 550, 551. Property of the estate found to be worthless to the estate should be abandoned by the trustee. *See* 11 U.S.C. § 554(a)(1).

In this case, the trustee sought to increase the property of the estate by using § 724(a) to avoid the penalty portion of a federal tax lien for the debtors' 2009 income tax liabilities. (ER-129–136.) Section 724(a) provides that a Chapter 7 trustee may "avoid a lien that secures a claim of a kind specified in section 726(a)(4) of this title." Section 726 deals generally with distribution of property of the estate in a Chapter 7 case. The relevant portion of § 726(a)(4) describes claims for "any fine, penalty, or forfeiture, or for multiple, exemplary, or punitive damages" that "are not compensation for actual pecuniary loss suffered by the

holder of such claim." *Cf. State of Wash., Emp. Sec. Dep't v. Hovan, Inc.* (*In re Hovan, Inc.*), 96 F.3d 1254, 1257-58 (9th Cir. 1996) (discussing how to determine whether a liability is a "penalty" and whether it is noncompensatory). Thus, § 724(a) allows the trustee to avoid the portion of a lien that secures a claim for noncompensatory penalties, including tax penalties. There is no dispute that the penalties at issue here are noncompensatory.

"Congress created avoidances of noncompensatory penalties to 'protect[ ] unsecured creditors from the debtor's wrongdoing.' " *DeMarah v. United States* (*In re DeMarah*), 62 F.3d 1248, 1252 (9th Cir. 1995) (quoting S. Rep. No. 95-989, at 96 (1978), *reprinted in* 1978 U.S.S.C.A.N. 5787, 5882); *see also* H.R. Rep. No. 95-595, at 382 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6338. Accordingly, the statute reflects Congress's view that "[p]enalties incurred by the debtor before the filing of the bankruptcy petition should not reduce the distribution to which the creditors are entitled, because the creditors could not prevent the accrual of the penalties." *U.S. Dep't of Interior v. Elliott*, 761 F.2d 168, 171 (4th Cir. 1985).

If a trustee avoids a lien on property of the estate using § 724(a), the lien (and with it its priority position) is automatically "preserved for the benefit of the estate." 11 U.S.C. § 551.[2] And this preserved property interest—*i.e.*, the lien securing the penalty—then becomes property of the estate. 11 U.S.C. § 541(a)(4). The effect of Section 551 is that "a trustee who avoids an interest succeeds to the priority that interest enjoyed over competing interests." *Retail Clerks Welfare Trust v. McCarty* (*In re Van de Kamp's Dutch Bakeries*), 908 F.2d 517, 519 (9th Cir. 1990); *see also United States v. Warfield* (*In re Tillman*), 53 F.4th 1160, 1164 (9th Cir. 2022); 5 *Collier on Bankruptcy* ¶ 551.02 (16th ed. 2023) ("the lien's priority remains the same as it was with respect to other liens prior to the avoidance"). The legislative history of § 551 also explains that it is not always true that lien avoidance and preservation will benefit the estate because some liens that are avoided may not have any value attributable to them. *See* H.R. Rep. No. 95-595, at 376 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6332 ("[P]reservation may

[2] Section 551 refers to the avoidance of a "transfer" under various provisions of the Bankruptcy Code, including § 724(a). The term "transfer" is defined to include "the creation of a lien." 11 U.S.C. § 101(54)(A); *see Hutchinson v. United States, Dep't of Treasury, IRS* (*In re Hutchinson*), 15 F.4th 1229, 1233 (9th Cir. 2021).

not benefit the estate in every instance.”). In such cases, the valueless lien may be abandoned by the trustee, *see id.*, and perhaps should not have been avoided at all. Avoidance of a valueless lien would incur expenses but would not benefit the estate.

C. Factual background

When the debtors filed for bankruptcy, they owned a home in Connecticut (“the Property”) for which they did not claim a homestead exemption. (Bankr. Doc. 1 at 12, 19-20.) In April 2020, with the approval of the Bankruptcy Court, the trustee sold the Property. (Bankr. Docs. 40, 63.) After paying the costs and expenses of sale and paying off the first mortgage, the estate was left with net proceeds of $38,642.80. (Bankr. Doc. 63 at 3; *see also* ER-129–136.) The Bankruptcy Court authorized the trustee to retain the funds “pending further order of the Court.” (Bankr. Doc. 40 at 3.)

The IRS filed a proof of claim that listed a secured claim of $81,174.13 for tax year 2009, consisting of (i) income tax of $26,900.19, (ii) interest on tax of $19,038.80, and (iii) penalties of $35,235.14

(including interest on penalties).[3] (ER-125–128.) The assessment for tax year 2009 was made in 2013. *Id.* And, while the IRS proof of claim did not list the date the notice of federal tax lien was filed for tax year 2009, the record elsewhere reflects that the IRS filed its notice of federal tax lien in 2013. (*See* ER-134.)

D. This adversary proceeding and the opinions below

In May 2020, the trustee filed an adversary proceeding seeking an order: (1) "avoiding the Tax Lien on the Property pursuant to 11 U.S.C. § 724(a)"; (2) preserving the avoided tax lien for the estate pursuant to § 551; (3) "[t]o the extent the Tax Lien is not avoidable, for the entry of an order determining and declaring that the sale proceeds of the Property shall be used to pay administrative expenses of the Chapter 7 estate"; and (4) "determining and declaring that the net sales proceeds of $38,642.80 shall be retained by the bankruptcy estate for distribution pursuant to 11 U.S.C. § 726 free and clear of any lien, claim, right, title or interest of the IRS." (ER-131.)

---

[3] Interest owed on a tax debt is generally considered an " 'integral part' " of the tax debt. *United States v. Ledlin* (*In re Mark Anthony Constr., Inc.*), 886 F.2d 1101, 1107-08 (9th Cir. 1989) (quoting *Bruning v. United States*, 376 U.S. 358, 360 (1964)).

1. Summary judgment proceedings

The trustee moved for summary judgment arguing that he could use § 724(a) to avoid the tax lien on the Property to the extent that it secures penalties and that the avoided portion of the lien would be automatically preserved under § 551. (Adv. Doc. 11 at 3-6, 9.) He maintained that, following avoidance, the IRS and the estate have "equal rights to the proceeds of that lien," and thus, that the proceeds of the lien should be split between the tax and penalty portions of the lien on a pro rata basis. (Adv. Doc. 11 at 6.) In addition, the trustee argued that the estate should be allowed to use § 724(b) to subordinate the unavoided tax portion of the lien and use it to pay administrative expenses under 11 U.S.C. § 507(a)(1)(C) and 507(a)(2). (Adv. Doc. 11 at 5.)

In its response, the Government did not dispute that the trustee could avoid the penalty portion of the tax lien using § 724(a) or that § 551 would automatically preserve the avoided penalty portion. (Adv. Doc. 18 at 2.) Instead, the Government argued that the trustee failed to properly allocate the proceeds of the sale of the Property because the proceeds should first be allocated to the tax portion of the

tax lien, *i.e.*, allocated tax first. (Adv. Doc. 18 at 2-14.) The Government relied in part on its interpretation of the distribution scheme in § 724(b), an argument that we are not renewing in this appeal. The Government also argued that even if the pro rata allocation method proposed by the trustee was correct, the trustee's calculations for his proposed pro rata split (*see* Adv. Doc. 11 at 7) were incorrect because he had not properly accounted for the possible setoff of a possible tax overpayment from the debtors' 2017 tax year (that was eventually allowed) because he simply assumed the setoff would only apply to the tax portion of the 2009 liabilities and not to the penalty portion. (Adv. Doc. 18 at 18-19.)

In his reply, the trustee again argued for a pro rata allocation (Adv. Doc. 26 at 3-10) and disputed "the 'tax first' position advocated by the IRS" (*id.* at 6-7). As to the possible setoff of the 2017 overpayment, the trustee claimed that the IRS was not free to apply the setoff at its discretion. (Adv. Doc. 26 at 11-14.)

2. The Bankruptcy Court's first opinion

The Bankruptcy Court held a hearing during which it issued an oral ruling granting the trustee's request to avoid the tax lien and

allocate the proceeds between the tax and penalty portions of the lien using a pro rata method. (ER-115, ER-117.) As to the treatment of the possible overpayment (which at that point had not yet been finally determined by the IRS), the court held that it was "premature . . . to rule on that issue simply because we don't yet know, in fact, whether there is going to be a refund." (ER-116.) As to the trustee's request that he be allowed to subordinate the tax portion of the tax lien under § 724(b), the court held that that would also be premature because there had not yet been a showing "that the Trustee's entitled to do that under [§] 724(e)." (ER-118–119.) The court directed the trustee's counsel to prepare an order consistent with the ruling. (ER-119.)

The Government objected to the trustee's proposed order because it stated fixed dollar values for the allocation between the tax and penalty portions of the lien, which the Government argued was improper since specific values might preclude a later adjustment of the allocation based on a setoff of the 2017 overpayment. (Adv. Doc. 34 at 4-5.) The Government also stated that the IRS had recently allowed the overpayment, and thus that the IRS was now in a position to decide

how to apply the overpayment to the 2009 tax liabilities as a setoff under I.R.C.§ 6402(a). (Adv. Doc. 34 at 3.)

The Bankruptcy Court overruled the Government's objection and issued an order that fixed the amount of the avoided penalty portion of the lien at $35,235.14 and the unavoided tax portion of the lien at $45,938.99. (ER-64.) The court denied the Government's motion (Adv. Doc. 40) to alter or amend the order. (ER-59–62.)

3. The District Court's first opinion

The Government appealed. (ER-159–161.) The Government continued to argue that § 724(b) was the applicable distribution provision (1st App. Doc. 7 at 15-30), and also argued that, in any event, the pro rata approach was not the correct allocation method and that a tax-first approach was correct (1st App. Doc. 7 at 30-39). In addition, the Government argued that the Bankruptcy Court had erred in issuing a ruling that determined the final allocation between the tax and penalty components of the 2009 tax lien before a final determination had been made as to the 2017 overpayment and setoff. (1st App. Doc. 7 at 40-45.)

The District Court affirmed in part, reversed in part, and remanded for further proceedings. (ER-34–58.) The District Court rejected the Government's § 724(b) argument (ER-46–52) and the Government's argument that even if § 724(b) did not apply, the Bankruptcy Court's use of a pro rata allocation method was improper (ER-52–57). On the latter point, the District Court found that the Bankruptcy Court "did not err by considering equitable principles (and performing a pro rata allocation pursuant to those principles) . . . ." (ER-54.) The District Court explained that "because pro rata allocation is not *in*consistent with § 551 and furthers the purposes of that provision, it was therefore permissible for the bankruptcy court to follow that approach pursuant to . . . [11 U.S.C.] § 105(a) . . . ." (ER-54–55.) The court further reasoned that while "the pro rata distribution has no basis in the Bankruptcy Code . . . a pro rata approach is not verboten under the Bankruptcy Code." (ER-56.) And it held that it was not the District Court's "role to substitute its judgment for that of the bankruptcy court where the bankruptcy court acted within its discretion and authority under the Bankruptcy Code." (ER-57.)

As to the overpayment setoff issue, the District Court held that the Bankruptcy Court had "erred in allocating specific amounts of the pro rata shares of the Proceeds when it had not yet determined whether the government was entitled to retroactively offset the balance owed on the Tax Lien." (ER-58.) It found that "[i]f the government is correct that it may apply the Refund to the Penalties portion of the Tax Lien retroactively, then the specific proportions of the Taxes and Penalties portions of the Tax Lien are subject to change, as are the pro rata shares of the Proceeds." (ER-58.) Thus, the District Court found that the Bankruptcy Court erred in reaching a specific allocation without first resolving that setoff question, and reversed and remanded so the Bankruptcy Court could consider that question in the first instance. (ER-58.)

4. The Bankruptcy Court's second opinion

After the remand, the parties submitted further briefing on the issue of the application of the 2017 overpayment. The Bankruptcy Court ultimately held that the Government was entitled to elect to apply the 2017 overpayment to the 2009 tax liability and that the application of the overpayment (based on the Government's election)

reduced the outstanding penalty portion of the 2009 tax lien. (ER-32.) Thus, the Bankruptcy Court issued a new final order adjusting the allocation of proceeds for the 2009 tax year to account for the setoff of the 2017 overpayment, but otherwise the court still employed the contested pro rata allocation method. (ER-32–33.)

5. The District Court's second opinion

Both parties appealed (ER-140–152), and the District Court affirmed (ER-5–24). The Government asked the District Court to reconsider its earlier ruling affirming the Bankruptcy Court's pro rata allocation method. The District Court "decline[d] to revisit" its earlier ruling on the pro rata allocation method. (ER-12–14.) The District Court affirmed the Bankruptcy Court on the trustee's cross appeal, holding that the Bankruptcy Court had correctly allowed the Government to offset the 2017 overpayment against the penalty portion of the 2009 tax lien. (ER-14–24.)

SUMMARY OF ARGUMENT

The courts below erred in adopting a pro rata method for allocating lien proceeds following lien avoidance under 11 U.S.C. § 724(a). The pro rata method improperly reduces the payments to

secured tax creditors on the tax portions of their claims. Section 724(a) was only intended to shield unsecured creditors from having the estate diminished by the payment of penalties. It was not intended to produce a windfall for unsecured creditors at the expense of the public fisc.

Section 724, which was enacted in 1978 as part of the new Bankruptcy Code, had its genesis in Section 57j of the prior Bankruptcy Act. As such this Court should interpret § 724(a) in a way that is consistent with preexisting bankruptcy law and practice, which disallowed government penalties but still ensured that the tax portions of secured tax claims were paid in full. While Congress broadened the protection offered in § 724(a) to include private penalties as well, neither the statutory nor legislative history supports interpreting § 724(a) in a way that reduces the amount paid on the tax portion of a tax lien. And given the negative result of the pro rata method, the courts below reached a conclusion that denies the government critical tax revenue far too lightly.

A tax-first approach is also more consistent with the fundamental bankruptcy principle—now embodied in many statutory provisions, and particularly in § 725—that the rights of secured creditors to their

collateral are protected, and thus that secured creditors must be paid first from the proceeds of their collateral. The pro rata approach runs afoul of this fundamental principle as it results in unsecured creditors being paid with the proceeds of property secured by a lien even before the secured creditor is allocated sufficient proceeds to fully pay the primary, non-penalty portion of the very same lien.

In adopting the pro rata method, the courts below erred in their reasoning in several ways. First, § 105(a) may only be used to implement some other Code provision and certainly cannot be used to violate the Code. But the pro rata approach does just that. It violates § 724(a), as properly interpreted in light of pre-Code practice. The pro rata approach also violates the fundamental bankruptcy principle, embodied in § 725 and other Code provisions, that secured creditors must be paid first from their collateral. And the District Court erred in suggesting that the method of allocation was a matter of discretion to be decided by the Bankruptcy Court. The proper allocation of the proceeds of a lien after lien avoidance under § 724(a) presents a legal question to which there should be only one right answer.

The District Court also based its reasoning on a belief that the Code treats similar creditors equally, but the court failed to recognize that the secured tax portion of a tax lien has historically still been paid. The court also failed to consider that income tax debts typically arise before any related penalties, which means that tax debts actually precede penalty debts. And thus, for several reasons, the penalty portion of a tax lien is not on equal footing with the tax portion.

For the reasons above, this Court should reverse and adopt a tax-first approach that ensures that an estate is not allowed to receive proceeds from the avoided penalty portion of a tax lien until sufficient proceeds have first been allocated to pay the unavoided tax portion of the lien.

ARGUMENT

Proceeds from the sale of property should be allocated first to the tax portion of a tax lien before any proceeds are allocated to the avoided penalty portion of the lien

Standard of review

This Court "review[s] de novo a district court's decision on appeal from a bankruptcy court." *Decker v. Tramiel* (*In re JTS Corp.*), 617 F.3d 1102, 1109 (9th Cir. 2010). As the second court of review, this Court

applies "the same standard of review applied by the district court" and "review[s] a bankruptcy court decision independently and without deference to the district court's decision." *Id.* Thus, " '[t]he bankruptcy court's findings of fact are reviewed for clear error, while its conclusions of law are reviewed de novo.' " *Id.* (quoting *Leichty v. Neary* (*In re Strand*), 375 F.3d 854, 857 (9th Cir. 2004)).

The interpretation of an avoidance power under the Bankruptcy Code is a legal question this Court reviews de novo. *Saslow v. Andrew* (*In re Loretto Winery Ltd.*), 898 F.2d 715, 718 (9th Cir. 1990). In reviewing how the Internal Revenue Code and the Bankruptcy Code interact, this Court has said that it "will not lightly assume that Congress intended to subordinate the efficacy of the federal tax laws to other considerations." *Battley v. United States* (*In re Berg*), 121 F.3d 535, 537 (9th Cir. 1997).

A. Introduction

The Bankruptcy Court held that after lien avoidance under § 724(a), the proceeds from the sale of encumbered property should be allocated pro rata between the tax portion of a tax lien and the avoided

penalty portion of the lien instead of through a tax-first approach. The District Court affirmed.

As will be shown, the pro rata allocation method adopted below should be rejected because it goes well beyond protecting unsecured creditors from the effects of penalties and instead creates a windfall for unsecured creditors by improperly increasing the estate at the expense of secured tax creditors—and thus ultimately at the expense of the Treasury. The correct approach—and the only one that interprets § 724(a) in a way that is consistent with longstanding bankruptcy law and practice—is to first allocate funds to the unavoided tax portion of a tax lien. Only after sufficient proceeds are allocated to satisfy the tax portion of a lien should the remaining proceeds be allocated to the avoided penalty portion of the lien.

B. Allocating proceeds first to the tax portion of a tax lien is the only approach that both interprets § 724(a) in a way that is consistent with long established bankruptcy law and practice and respects the fundamental bankruptcy principle that secured creditors must be paid first from their collateral

The text of § 724(a) does not directly answer the question of how to allocate sale proceeds between the non-penalty and penalty portions of a lien after the penalty portion of the lien has been avoided under

§ 724(a). Nor does the text of § 551, the related preservation provision. The District Court implicitly recognized that §§ 724(a) and 551 do not expressly address the allocation issue presented here. (ER-53–54.) *See also United States v. Warfield* (*In re Freeman*), 2023 WL 2665735, at *10 (D. Ariz. Mar. 28, 2023) ("Sections 724(a) and 551 . . . do not set forth any particular allocation method."), *appeal pending*, No. 23-15827 (9th Cir.). So this Court will have to look beyond the text of the Code to decide how to interpret these provisions and determine which allocation method is correct.

1. The statutory and legislative history support interpreting § 724(a) in a way that ensures that the tax portion of a tax lien is paid first

To properly interpret the Bankruptcy Code, courts must often consider the statutory and legislative history behind each provision. "When Congress amends the bankruptcy laws, it does not write 'on a clean slate.' " *Dewsnup v. Timm*, 502 U.S. 410, 419 (1992) (quoting *Emil v. Hanley*, 318 U.S. 515, 521 (1943)). Consistent with this principle, this Court has held that courts must "presume, absent clear indications to the contrary, that Congress did not intend to change preexisting bankruptcy law or practice in adopting the Bankruptcy

Code in 1978 or in amending it in 1984."[4] *Pac. Gas & Elec. Co. v. California*, 350 F.3d 932, 943 (9th Cir. 2003). And "[t]he Supreme Court has made clear that it 'will not read the Bankruptcy Code to erode past bankruptcy practice absent a clear indication that Congress intended such a departure.' " *Ad Hoc Comm. of Holders of Trade Claims v. Pac. Gas and Elec. Co.* (*In re PG&E Corp.*), 46 F.4th 1047, 1057-58 (9th Cir. 2022) (quoting *Cohen v. de la Cruz*, 523 U.S. 213, 221 (1998)); *see also Dewsnup*, 502 U.S. at 419 (explaining that vague language in the Code should not normally be interpreted in a way that would "effect a major change in pre-Code practice that is not the subject of at least some discussion in the legislative history").

i. The history and purpose of § 724(a)

Section 724(a) of the Bankruptcy Code of 1978 had its genesis in Section 57j of the prior Bankruptcy Act, former 11 U.S.C. § 93(j). *See* H.R. Rep. No. 95-595, at 382 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6338; S. Rep. No. 95-989, at 96 (1978), *reprinted in* 1978

---

[4] This Court has explained that this presumption is based on "a remarkably consistent series of [Supreme Court] cases" that "explicitly and repeatedly relied on this presumption." *Pac. Gas & Elec. Co.*, 350 F.3d at 943 (collecting cases).

U.S.S.C.A.N. 5787, 5882; *see also* 11 U.S.C.A Disposition Table (West 2023). Section 57j of the Bankruptcy Act provided that all government penalty claims (tax or non-tax) were disallowed:

> Debts owing to the United States or to any State or any subdivision thereof as a penalty or forfeiture shall not be allowed, except for the amount of the pecuniary loss sustained by the act, transaction, or proceeding out of which the penalty or forfeiture arose, with reasonable and actual costs occasioned thereby and such interest as may have accrued on the amount of such loss according to law.

Former 11 U.S.C. § 93(j) (1976 ed.). The Supreme Court interpreted Section 57j to disallow not only unsecured government claims for noncompensatory penalties but to disallow secured government penalty claims as well. *Simonson v. Granquist*, 369 U.S. 38, 40 (1962); *see also State Bd. of Equalization v. Stodd* (*In re P.R.O. Enters., Inc.*), 500 F.2d 1208, 1210 (9th Cir. 1974) (citing *Simonson*, 369 U.S. at 38) ("Once funds are part of the bankrupt estate, they may not be used to pay tax penalties and post-petition interest under [Section] 57j. Even penalty claims secured by liens on the bankruptcy assets are not allowable in bankruptcy."). Thus, under pre-Code practice, noncompensatory penalties owed to a governmental unit were neither allowed nor paid in

bankruptcy even if the governmental unit had a lien securing the penalties.

In reaching this result in *Simonson*, the Supreme Court explained that the policy of disallowing government penalty claims, whether secured or not, made sense because the "[e]nforcement of penalties against the estates of bankrupts . . . would serve not to punish the delinquent taxpayers, but rather their entirely innocent creditors." *Simonson*, 369 U.S. at 41. And even after reviewing another statutory provision that protected the rights of secured creditors, the Court concluded that "we find nothing that indicates a purpose to require the general creditors of a bankrupt to suffer because of penalties designed to be inflicted upon the bankrupt himself." *Id.; see also id.* at 40. But Section 57j affected only the penalty portion of a secured governmental claim. Thus, under the Bankruptcy Act and *Simonson*, when the IRS had a tax lien that covered both tax and penalties, the IRS would still be paid the full value of the tax portion of its secured tax claim (both tax and prepetition interest on tax) up to the value of the collateral.

When Congress enacted the Bankruptcy Code of 1978, Congress chose to expand the protective policy of prior Section 57j. *See* H.R. Rep.

No. 95-585, at 382 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6338 (explaining that § 724(a) "expands the protection afforded" by Section 57j); S. Rep. No. 95-989, at 96 (1978), *reprinted in* 1978 U.S.S.C.A.N. 5787, 5882 (same). Now, under § 724(a), a Chapter 7 trustee may avoid liens securing penalties and other noncompensatory claims of both *public* and *private* creditors. Simultaneously, Congress then provided in § 726(a)(4) for the allowance of penalty claims and other noncompensatory claims (of both public and private creditors) but only in a subordinated priority below general unsecured creditors in Chapter 7 liquidations.[5] *See* 11 U.S.C. § 726(a)(2), (3). Thus, the combination of §§ 724(a) and 726(a)(4) now more fully ensures that penalties and other noncompensatory claims do not reduce the amount of the estate available to pay the claims of unsecured creditors. And this in turn better ensures that unsecured creditors are not inadvertently punished because of the debtor's misconduct—the original goal of Section 57j. But nothing in the statutory or legislative history of § 724(a) suggests

[5] This also meant that governmental noncompensatory penalties were being allowed for the first time. Allowing such penalties at a very low priority had the effect of ensuing that a debtor would not receive a payment of surplus funds from the estate without first having to pay noncompensatory penalties. *See* 11 U.S.C. § 726(a)(4), (6).

that § 724(a) was intended to change the substantive result under prior bankruptcy practice and *Simonson* that the non-penalty portion of a secured government claim would still be paid in full, up to the value of the collateral. Nor does anything suggest that § 724(a) was intended to increase the payout received by unsecured creditors at the expense of a secured creditor holding a non-penalty claim. *Cf. In re PG&E Corp.*, 46 F.4th at 1057-58 (courts should "not read the Bankruptcy Code to erode past bankruptcy practice absent a clear indication that Congress intended such a departure" (internal quotation marks and citation omitted)).

ii. The history and purpose of § 551

The automatic preservation provision in Section 551 was new to the Code. Under both the prior Bankruptcy Act and the prior bankruptcy rules (based on the Bankruptcy Act) avoided liens were not automatically preserved, but the court could order an avoided lien preserved. *See Van de Kamp's Dutch Bakeries*, 908 F.2d at 519 (citing John C. Chobot, *Preserving Liens Avoided in Bankruptcy—Limitations and Applications*, 62 Am. Bankr. L.J. 149, 157 (1988)) (discussing the statutory and legislative history of 11 U.S.C. § 551). This meant that

the default situation after avoidance was that junior secured creditors would move up in priority, obtaining greater security for their debts because of lien avoidance. Only if the avoided transfer was specifically preserved would the estate directly benefit.[6]

In adopting the new Code, Congress chose to simplify things and make the preservation of avoided liens automatic. 11 U.S.C. § 551. Thus, now, "a trustee who avoids an interest succeeds to the priority that interest enjoyed over competing interests." *Van de Kamp's Dutch Bakeries*, 908 F.2d at 519. Section 551 thereby "prevents junior lienors from improving their position at the expense of the estate when a senior lien is avoided." H.R. Rep. No. 95-595, at 376 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6332. Section 551 is thus consistent with an outcome already generally achievable for avoidance actions under the Bankruptcy Act.[7] And so, under long established bankruptcy practice,

---

[6] The estate would sometimes indirectly benefit because paying a junior secured creditor from collateral that otherwise would have gone to a senior lien for a penalty means a smaller part of that junior lienor's claim is left as unsecured and that, in turn, means that other unsecured creditors may be paid more from unencumbered assets.

[7] The only minor difference between the outcome under the prior Bankruptcy Act and the current Code as to government penalty liens is that under the Bankruptcy Act government penalties were simply

(continued…)

the Government should still be paid in full for the tax portion of a secured tax lien before the avoided penalty portion of the lien is paid to unsecured creditors.

iii. The avoidance of noncompensatory penalties under § 724(a) was merely intended to prevent the estate from being diminished by penalties, it was not meant to create a windfall for unsecured creditors as the pro rata approach does

What is clear from examining the statutory and legislative history, is that Congress intended the avoidance of noncompensatory penalties "to 'protect[] unsecured creditors from the debtor's wrongdoing.' " *DeMarah*, 62 F.3d at 1252 (quoting S. Rep. No. 95-989, at 96 (1978), *reprinted in* 1978 U.S.S.C.A.N. 5787, 5882); *see also Gill v. Kirresh* (*In re Gill*), 574 B.R. 709, 716 (B.A.P. 9th Cir. 2017) ("Enforcement of penalties against a debtor's estate serves not to punish the delinquent taxpayers, but rather their entirely innocent creditors.");

---

disallowed (not avoided), *see* former 11 U.S.C. § 93(j) (1976 ed.) (Bankruptcy Act § 57j), and also not preservable, *see* former 11 U.S.C. § 107(c)(4) (1976 ed.) (Bankruptcy Act § 67c(4)). Now, the penalty liens are both avoided and preserved under §§ 724(a) and 551. This difference might affect how much is paid toward junior liens, if any, in that junior liens no longer move up in priority. But this change should not be held to affect how much is paid to the principal and interest portion of the same lien.

IRS v. Baldiga (*In re Hannon*), 619 B.R. 524, 534 (D. Mass. 2020) (same). But the pro rata approach does more than simply shield unsecured creditors from being punished for the debtor's wrongdoing; the pro rata approach goes perniciously further. It imposes the burden of a debtor's misconduct on the secured creditor against whom the misconduct was originally committed by reducing the share of the secured creditor's own collateral used to pay the unavoidable non-penalty portion of its secured claim. This creates a bizarre result, in which a secured tax creditor would receive less under a pro rata approach when the very same tax is owed and secured but increasing penalty amounts are owed.

For example, compare three hypothetical Chapter 7 debtors: each of whom owes $100,000 in unpaid federal income tax and has a tax lien on their $100,000 real property. The first debtor owes $5,000 in related penalties, and thus owes a total of $105,000; the second debtor owes $25,000 in related penalties, and thus owes a total of $125,000; and the third debtor owes $70,000 in related penalties, and thus owes a total of $170,000. After lien avoidance under § 724(a), and under the pro rata allocation method applied by the courts below, the IRS would be

allocated $95,238 (100/105) for the first hypothetical debtor, $80,000 (100/125) for the second, and $58,823 (100/170) for the third. In contrast, under the tax-first approach, the IRS would be allocated $100,000 in each case because the same tax lien secures the same tax debt.

These numbers demonstrate the absurd result reached by the pro rata approach. Under that approach, the greater the debtor's misconduct (and consequently, the more penalties owed), the less tax is collected.

Nor should it be ignored that the pro rata approach would also harm private secured creditors whose liens include avoidable penalty portions. For instance, a private secured creditor that holds a judgment lien on a $100,000 property that secured a $400,000 judgment for compensatory damages of $100,000 and punitive damages of $300,000 would be allocated only $25,000 of the $100,000 in proceeds under a pro rata allocation following avoidance of the punitive damages portion of the lien. The other $75,000 would be allocated to punitive damages and go to the estate, providing a windfall to unsecured creditors. A particularly odd result—and one made even more peculiar given that a

tort judgment could be for actions like embezzlement, fraud, or conversion, and the estate may be in possession of the very same $100,000 in value that the debtor wrongfully obtained. Similarly, lenders would be harmed by the pro rata approach since any added late fees and late-payment penalties secured by a mortgage are avoidable under § 724(a). Assume that there is a mortgage debt of $110,000, that consists of $100,000 in principal debt (the amount lent to the debtor) and $10,000 in late fees. The pro rata approach would result in an allocation to the mortgage of only $90,909 of the $100,000 lent (and now represented by $100,000 in proceeds).

These results are inequitable. In each of the above hypotheticals, the tax creditor, the judgment creditor, or the mortgagee would be better off had the penalties, punitive damages, or noncompensatory fees never been imposed. These examples illustrate that the pro rata approach does not simply protect the estate from paying penalties, but also creates a windfall for the estate by reducing the payments to a secured creditor on the unavoided portion of the lien. And the greater the misconduct, the larger the bonanza (for the unsecured creditors).

The pro rata approach appears even more irrational when considering that the main purpose of a tax lien is to secure the collection of taxes—*i.e.*, to secure the " 'lifeblood of government.' " *See Berg*, 121 F.3d at 537 (quoting *Bull v. United States*, 295 U.S. 247, 259 (1935)); *see also Bull*, 295 U.S. at 259 ("[T]axes are the lifeblood of government, and their prompt and certain availability an imperious need."). Securing the collection of any related penalties is a secondary function of a tax lien. *See* I.R.C. § 6321 (creating a tax lien that also covers additional liabilities). To allow the existence of such secondary penalties to be used to reduce the amount of tax collected by the government for the same lien—that is, to permit the secondary purpose to thwart the primary purpose—is like allowing the tail to not only wag the dog, but strangle it.

Yet that is precisely what the courts below did here when adopting the pro rata approach. They allowed the avoided penalty portion of the tax lien to unnecessarily diminish the collection on the tax portion of the lien. And, in doing so, the courts not only substantially diminished the efficacy of federal tax liens, but they treated such reductions far too lightly. *See Berg*, 121 F.3d at 537 (in

reviewing how the Internal Revenue Code and the Bankruptcy Code interact, this Court "will not lightly assume that Congress intended to subordinate the efficacy of the federal tax laws to other considerations").

Notably, after the Bankruptcy Court's original decision in this case, the Bankruptcy Court for the Eastern District of California issued an opinion that explicitly adopted a tax-first approach to allocating the proceeds between the tax and penalty portions of tax liens following lien avoidance under § 724(a). *In re Hutchinson*, No. 17-bk-12272, 2022 WL 1021843, at *4 (Bankr. E.D. Cal. Apr. 1, 2022), *appeal pending*, No. EC-22-1078 (B.A.P. 9th Cir.). The court held that a tax-first approach "is consistent with 11 U.S.C. § 724(a), which avoids only the same portion of a tax lien that is also subordinated in § 726(a)(4) . . . ." *Id.* at *4. And it held that the tax-first approach ensures that the penalty portion of a lien is subordinate to the tax portion of a lien. *Id.*

This Court too should adopt the same tax-first, priority allocation method recently adopted by the Bankruptcy Court in *Hutchinson*. A tax-first allocation is the only approach that is consistent with past bankruptcy practice and that does not needlessly subordinate the efficacy of the federal tax laws.

2. It is a fundamental bankruptcy principle that the interests of secured creditors in their collateral are protected, and thus, that secured creditors are entitled to be paid first

It is a fundamental bankruptcy principle that the interests of secured creditors are protected, and thus that secured creditors are entitled to be paid first out of their collateral before those funds are used to pay unsecured creditors. *See* 4 *Collier on Bankruptcy* ¶ 506.02 (16th ed. 2023); *see also United States v. Darnell* (*In re Darnell*), 834 F.2d 1263, 1265 (6th Cir. 1987) ("[A]s a general rule, if a lien is perfected, it must be satisfied out of the asset(s) it encumbers before any proceeds of the asset(s) are available to unsecured claimants, including those having priority (such as holders of administrative claims)."). This principle is now enshrined in many Code provisions. And while no Code provision explicitly states that secured creditors must be paid first from their collateral before unsecured creditors, this has long been understood to be true and the case law makes it clear.[8]

---

[8] This policy is rooted in the prior Bankruptcy Act, which only allowed secured creditors to prove claims against the estate beyond the amount of their collateral—because the secured creditors were understood to be collecting first from their collateral. *See* former 11 U.S.C. § 93(e) (1976 ed.) (Bankruptcy Act § 57e).

Czyzewski v. Jevic Holding Corp., 580 U.S. 451, 457 (2017) (citing 11 U.S.C. § 725) ("Secured creditors are highest on the priority list, for they must receive the proceeds of the collateral that secures their debts."); *Hartford Underwriters Ins. Co. v. Union Planters Bank, N.A.*, 530 U.S. 1, 5 (2000) ("Administrative expenses . . . do not have priority over secured claims . . . ." (internal citation omitted)).

This is because secured creditors hold interests in the debtor's property superior to those of the estate. The legislative history to the current Code explains that Congress has intentionally adopted a bankruptcy policy, consistent with the Takings Clause of the Fifth Amendment, in which secured creditors are not to be unnecessarily "deprived of the benefit of their bargain." H.R. Rep. No. 95-595, at 339 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6295; *see Dewsnup*, 502 U.S. at 419 (noting Fifth Amendment concerns connected with stripping down a lien to the value of a secured creditor's collateral). And thus, the Code contains many provisions designed to ensure that secured creditors are indeed paid the full value of their collateral and not thwarted by the bankruptcy process. These provisions generally protect both voluntary and involuntary secured creditors alike.

Perhaps the provision that most embodies the special status of secured creditors in Chapter 7 is § 725, which generally applies to the disposition of "property . . . in which an entity other than the estate has an interest, such as a lien . . . ."[9] The import of § 725 is that secured creditors are entitled to be paid first from their collateral, and the Supreme Court has cited § 725 to that effect. *See* 6 *Collier on Bankruptcy* ¶ 725.01 (16th ed. 2023) ("Section 725 is in lieu of a provision that would direct a certain distribution to secured creditors"); *Czyzewski*, 580 U.S. at 455, 457, 464 (citing § 725); *Hartford Underwriters*, 530 U.S. at 5 (citing § 725). Section 725 ensures that entities other than the estate will have their interests satisfied before any excess proceeds go to the estate and are distributed to unsecured creditors in accordance with § 726. *See Czyzewski*, 580 U.S. at 457.

This basic principle that the interests of secured creditors are protected can also been seen in other Code provisions, such as §§ 361 and 363. Section 361 entitles all secured creditors to adequate protection from diminishment of their secured interest due to use or

---

[9] This same policy requiring secured creditors to be paid first is also embodied in 11 U.S.C. §§ 1129(b)(2)(A), 1225(a)(5), and 1325(a)(5), which apply in cases under other Chapters of the Code.

sale in the ongoing bankruptcy. This protection is provided in the form of cash payments, replacement liens, or other necessary relief, all of which are intended to ensure that the secured creditor ultimately receives "the indubitable equivalent of such entity's interest in such property." 11 U.S.C. § 361. Similarly, under § 363, estate property generally cannot be sold or used without proper notice to lienholders. *See* 11 U.S.C. § 363. And § 363 specifically provides that secured creditors have a right to "adequate protection" as part of the condition of any sale—thereby ensuring that they ultimately receive the full secured value to which they are entitled. 11 U.S.C. § 363(e). Additional protections are provided in other sections, such as 11 U.S.C. §§ 506(b), 552, 553, and 554.

To be sure, § 724(a) represents an exception to the norm in that § 724(a) (together with § 551) provides the estate with a limited ability to invade the secured creditor's right to collect any penalty amount from its collateral and gives that right to the estate to protect the estate from being diminished by paying penalties. But this limited exception should not be interpreted so broadly that it undermines a secured creditor's right to payment of non-penalty claims secured by the same

lien. *Cf. Czyzewski*, 580 U.S. at 465 ("more than simple statutory silence" is required to conclude that Congress "intend[s] a major departure" from a fundamental principle of bankruptcy law). After lien avoidance under § 724(a), each tax lien still secures a tax claim, and the Government is still entitled to be paid the full amount of the tax owed. Where, as here, there are insufficient proceeds to pay both the tax and the avoided penalty portion of the tax lien in full, the tax portion of the lien should be paid first. Reducing the amount paid on the tax portion of the lien, as the pro rata approach does, does not fulfill the purpose of § 724(a) and is inconsistent with the special protections owed to secured creditors. Since the purpose of § 724(a) is simply to stop the estate from being diminished by penalties, the estate should only be entitled to receive excess proceeds. Only a tax-first allocation is consistent with the fundamental bankruptcy principle protecting secured creditors' special rights to their collateral.

C. The contrary reasoning of the courts below is unpersuasive

1. The District Court improperly relied on 11 U.S.C. § 105 to adopt a pro rata approach that violates § 724(a)—as can be seen after § 724(a) is properly interpreted based on pre-Code practice

The District Court held that the pro rata approach was a permissible approach for the Bankruptcy Court to adopt using its authority under §105(a), which provides that a bankruptcy court "may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title." (ER-52, ER-54, ER-57.) The District Court reasoned that the pro rata approach is not expressly forbidden or inconsistent with the other provisions of the Code and that it fulfills the purpose of avoidance and preservation, which generally allows the trustee to obtain the lien for the benefit of the estate and thereby step into the lienholder's shoes. (ER-54–57.) The District Court's reliance on § 105(a) is misplaced.

Section 105(a) is "an omnibus provision," with a "basic purpose . . . to assure the bankruptcy courts power to take whatever action is appropriate or necessary in aid of the exercise of their jurisdiction." 2 *Collier on Bankruptcy* ¶ 105.01 (16th ed. 2023). The Supreme Court

has said that § 105(a) is the source of the bankruptcy courts' traditionally "broad equitable power." *See Johnson v. Home State Bank*, 501 U.S. 78, 88 (1991) (citing 11 U.S.C. § 105(a) and stating that the bankruptcy courts have "retain[ed]" their "broad equitable power"). But the Court has also made clear that "whatever equitable powers remain in the bankruptcy courts must and can only be exercised within the confines of the Bankruptcy Code." *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197, 206 (1988); *see Law v. Siegel*, 571 U.S. 415, 421 (2014) (same). And, since § 105(a) is designed to merely help "carry out" the Code, this means that § 105(a) cannot be used to "contravene" or contradict the Code. *Law*, 571 U.S. at 420-22, 427-28; *see also id.* at 421 ("Section 105(a) confers authority to 'carry out' the provisions of the Code, but it is quite impossible to do that by taking action that the Code prohibits."); *Saxman v. Educ. Credit Mgmt. Corp.* (*In re Saxman*), 325 F.3d 1168, 1174 (9th Cir. 2003) (explaining that a bankruptcy court " 'may exercise its equitable power only as a means to fulfill some specific Code provision.' " (quoting *In re Fesco Plastics Corp.*, 996 F.2d 152, 154 (7th Cir. 1993)).

The District Court's reliance on § 105(a) is misplaced because whatever authority § 105(a) provides it cannot be used to violate the Code. And adopting a pro rata approach under § 105(a) does just that. A pro rata approach not only (i) violates the rights of creditors under § 724(a) to continue to collect the unavoided portion of their secured claims—as can be seen once that provision is properly interpreted in light of pre-Code practice—but also (ii) violates the fundamental bankruptcy principle that secured creditors should be paid first from their collateral before any funds go to unsecured creditors, which is embedded in § 725 and other Code provisions. *See* discussion at pp. 31-41, *supra*.

The District Court (and implicitly the Bankruptcy Court too) failed to appreciate the statutory and legislative history of § 724(a), and thus the court failed to interpret § 724(a) in a way that did not conflict with and undermine the pre-Code practice of paying secured tax claims in full even while disallowing secured penalties. As shown above, § 724(a) was intended to expand the protection of the estate from penalties and other noncompensatory claims. There is nothing to suggest Congress intended to undermine the clearly established pre-

Code practice that ensured that secured tax creditors would still be paid the tax portion of a tax claim from their security—even as the penalty portion was disallowed.

Thus, this Court should hold that § 724(a) did not implicitly change the established bankruptcy practice of paying the full non-penalty portion of a secured government claim. And this in turn also means that this Court should hold that § 105(a) cannot be used to adopt a pro rata approach that violates § 724(a). As such, the District Court thus erred not only in its interpretation of § 724(a) but in its reliance on § 105(a). The pro rata allocation of a portion of the proceeds to the estate here was not "necessary and appropriate" to carry out the provisions of the Code. Rather, it was at odds with them. Accordingly, the pro rata allocation was not a valid exercise of the Bankruptcy Court's power under § 105(a).

The District Court also erred in concluding that the pro rata allocation method was within the Bankruptcy Court's discretion. (*See* ER-57 (stating that the Bankruptcy Court "acted within its discretion and authority under the Bankruptcy Code"). But treating the allocation of proceeds following lien avoidance under § 724(a) as a matter of

discretion is improper. Matters of discretion can vary from case to case. And, quite simply, the amount paid to a government tax creditor for a secured tax lien should not be allowed to vary from case to case (like the length of the Chancellor's foot). There must be one right answer to the legal question of how to allocate funds following lien avoidance under § 724(a). And, in any event, the proper interpretation of § 724(a) in light of pre-Code practice is a question of law, not discretion.

2. Equality of treatment for equal creditors is the norm, but this case does not involve that principle since the tax and penalty portions of a tax lien are not on equal footing

To the extent the District Court adopted the pro rata approach to ensure the equality of treatment of the tax and penalty portions of the same lien (ER-56), it went too far and failed to properly interpret § 724(a). It is true that the Code generally espouses the equality of treatment of unsecured creditors of the same priority class. *See, e.g.*, 11 U.S.C. §§ 507, 726; *Begier v. IRS*, 496 U.S. 53, 58 (1990) (citing 11 U.S.C. § 726(b); additional citation omitted) ("Equality of distribution among creditors is a central policy of the Bankruptcy Code. According to that policy, creditors of equal priority should receive pro rata shares of the debtor's property."). But that is not usually the case for secured

creditors whose interests are normally put in front of unsecured creditors, and then rank ordered amongst each other. *See Czyzewski*, 580 U.S. at 457 ("Secured creditors are highest on the priority list, for they must receive the proceeds of the collateral that secures their debts. 11 U.S.C. § 725."); *id.* ("The Code makes clear that distribution of assets in a Chapter 7 liquidation must follow this prescribed order. §§ 725, 726."). It may be true that in a rare instance where secured creditors have interests tied in priority, such as where liens have attached simultaneously to after-acquired property, those secured creditors might then share equally, but that is not really what is happening here. This is not a case that involves competing secured creditors that are all tied in priority and need to divide insufficient funds.

This case instead involves the different question of how to divide the proceeds of a tax lien, between the unavoided tax portion of the lien and the avoided penalty portion of the same lien. And pre-Code practice indicates that § 724(a) should be interpreted in a way that ensures that the tax portion of a tax lien is still paid first even while the estate is protected from being diminished by penalties—meaning a tax-first allocation. A tax-first allocation is also the most consistent with the

principle underlying § 725 and other provisions designed to ensure secured creditors are protected and paid first from their collateral before unsecured creditors receive anything. The trustee may now hold the avoided penalty portion of a tax lien, but that does not mean the penalty portion of the lien is truly on equal footing with the tax portion of the lien. The substantive result of *Simonson*, 369 U.S. at 40-41, discussed at pp. 26-29, *supra*, in which the tax portion of the same tax lien was still paid in full, should still apply.

Furthermore, income tax debts and related penalties are not truly on equal footing because income tax debts accrue first. An income tax debt typically arises at the end of each tax year. *See Towers v. United States* (*In re Pac.-Atl. Trading Co.*), 64 F.3d 1292, 1295, 1301 (9th Cir. 1995); *see also United States v. Martin* (*In re Martin*), 542 B.R. 479, 491 (B.AP. 9th Cir. 2015). Penalties, however, do not begin to accrue until after some additional conduct or failure to perform a legal duty has occurred, such as failing to file a timely tax return or pay an amount owed when due. *See* I.R.C. § 6651(a). Put, simply, "it is the tax which comes first. It is the tax which is the genesis of the interest and penalty." *In re Seneca Balance, Inc.*, 114 B.R. 378, 379 (Bankr.

W.D.N.Y. 1990). For this reason, too, this Court should hold that any lien funds should first be applied to the tax portion of the tax lien. *See In re Specialty Cartage, Inc.*, 115 B.R. 164,166-67 (Bankr. N.D. Ind. 1989) (reasoning that the collateral of an undersecured tax lien "should be allocated first to the principal and interest due on account of the tax and then to any penalties"), *aff'd sub nom., United States v. Specialty Cartage, Inc.*, 113 B.R. 484 (N.D. Ind. 1990); *see also Seneca Balance*, 114 B.R. at 379 (reasoning that "[o]nly if the value is adequate to cover the entire lien, should the interest and the penalty be secured").

3. The fact that here the penalty portion of the tax lien happens to be out of the money should not be allowed to obscure the fact that lien avoidance under § 724(a) will still often benefit the estate even after a tax first allocation

The trustee argued in the District Court that a tax-first approach is wrong because it results in no value being allocated to the penalty portion of the lien. (1st App. Doc. 10 at 6-7, 13.) The District Court appeared to agree with this argument. (ER-55.) But it is important to recognize that that will only be the result in cases like this one in which there are insufficient funds to pay the tax portion of the lien. Here, the amount of the tax lien (after application of the 2017 overpayment) was

$70,929, consisting of tax (including interest) of $45,939 and penalties of $24,991. The sale proceeds of $38,643 should be allocated first to the tax portion of the lien, leaving no part of the proceeds to be allocated to the penalty portion. If the proceeds had been more than $45,939, then under the tax-first approach the tax portion of the lien would have been paid in full, with the remainder allocated to the penalty portion (and therefore to the estate). *Cf. Hutchinson*, 2022 WL 1021843, at *4 (stating that $5,495 would be allocated to the penalty portion of the lien under the tax-first approach). It is only where a tax lien is undersecured that the penalty portion of the lien may go fully or partially unpaid. But that is the nature of scarcity in bankruptcy; at some point the value always runs out. And, under the facts of this case, the meager available funds will first be exhausted by being allocated to the unavoided tax portion of the lien. The fact that avoidance and preservation of the penalty portion of the lien does not result in any benefit for the estate in this case is not a problem. The legislative history of § 551 shows that Congress recognized that "preservation may not benefit the estate in every instance." H.R. Rep. No. 95-595, at 376 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6332.

It is also worth observing that the estate may yet benefit from the funds that are first allocated to the tax portion of a tax lien. Section 724(b) provides a second exception to the rule that secured creditors are paid first out of their collateral because it allows the trustee to subordinate the unavoidable tax portion of a tax lien to pay certain preferred priority creditors, including expenses of administration. *See N. Slope Borough v. Barstow* (*In re MarkAir, Inc.*), 308 F.3d 1057, 1064 (9th Cir. 2002) ("The express text of § 724(b) subordinates the interests of tax lienholders to that of priority unsecured creditors, but only up to the total amount of the tax lien."). In cases in which the priority creditors listed in § 724(b)(2) remain unpaid after the trustee has already "exhaust[ed] the unencumbered assets of the estate," *see* § 724(e)(1), then the trustee may redirect the payment of the unavoided tax portion of a tax lien to those priority creditors. Thus, the estate might still share in the tax portion of the tax lien even after a tax-first allocation.[10]

---

[10] In fact, in this case, the trustee already sought to use § 724(b) to subordinate the unavoided tax portion of the lien and use it to pay administrative expenses under 11 U.S.C. § 507(a)(1)(C) and 507(a)(2). (Adv. Doc. 11 at 5.) The Bankruptcy Court held that that would be

(continued…)

To be sure, Congress intended to expand the protection from government penalties previously afforded under the Bankruptcy Act when it amended the Code and enacted § 724(a) to protect the estate from both public and private penalties. But that does not mean that Congress intended for the estate to be newly enriched by also depriving secured creditors of the unavoided portion of the same lien. The change made to what is now § 724(a) to protect the estate from additional penalties should not be twisted into creating a windfall for unsecured creditors at the expense of secured tax creditors. In light of and consistent with prior bankruptcy practice, this Court should adopt a tax-first approach and hold that an estate should not be allowed to receive any proceeds related to the avoided penalty portion of a lien until sufficient proceeds have first been allocated to pay in full the unavoided portion of the lien.

---

premature because there had not yet been a showing "that the Trustee's entitled to do that under [§] 724(e)." (ER-118–119.) Accordingly, the court denied without prejudice the trustee's request for an order determining that the unavoided portion of the lien be used under § 724(b) to pay administrative expenses. (ER-64; ER-27.)

CONCLUSION

For the reasons above, the District Court's judgment affirming the Bankruptcy Court should be reversed, and the case should be remanded with instructions that all of the sale proceeds of $38,643 should be allocated to the tax portion of the federal tax lien.

Respectfully submitted,

DAVID A. HUBBERT
Deputy Assistant Attorney General

/s/ Matthew S. Johnshoy

BRUCE R. ELLISEN (202) 514-2929
MATTHEW S. JOHNSHOY (202) 616-1908
Attorneys
Tax Division
Department of Justice
Post Office Box 502
Washington, D.C. 20044

Of Counsel:
GARY M. RESTAINO
United States Attorney

OCTOBER 2, 2023

ADDENDUM

Page

Bankruptcy Code (11 U.S.C.)

§ 105 (excerpt) 55

§ 361 55

§ 363 (excerpts) 56

§ 551 58

§ 724 58

§ 725 60

§ 726 61

Bankruptcy Act of 1898 (1976 ed.) (Former 11 U.S.C.)

§ 93 (excerpt) 64

§ 107 (excerpt) 64

Internal Revenue Code (26 11 U.S.C.)

§ 6321 65

§ 6322 65

§ 6323 (excerpts) 65

Bankruptcy Code (11 U.S.C.)

§105. Power of court

(a) The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title. No provision of this title providing for the raising of an issue by a party in interest shall be construed to preclude the court from, sua sponte, taking any action or making any determination necessary or appropriate to enforce or implement court orders or rules, or to prevent an abuse of process.

* * *

§361. Adequate protection

When adequate protection is required under section 362, 363, or 364 of this title of an interest of an entity in property, such adequate protection may be provided by—

(1) requiring the trustee to make a cash payment or periodic cash payments to such entity, to the extent that the stay under section 362 of this title, use, sale, or lease under section 363 of this title, or any grant of a lien under section 364 of this title results in a decrease in the value of such entity's interest in such property;

(2) providing to such entity an additional or replacement lien to the extent that such stay, use, sale, lease, or grant results in a decrease in the value of such entity's interest in such property; or

(3) granting such other relief, other than entitling such entity to compensation allowable under section 503(b)(1) of this title as an administrative expense, as will result in the realization by such entity of the indubitable equivalent of such entity's interest in such property.

§363. Use, sale, or lease of property

(a) In this section, "cash collateral" means cash, negotiable instruments, documents of title, securities, deposit accounts, or other cash equivalents whenever acquired in which the estate and an entity other than the estate have an interest and includes the proceeds, products, offspring, rents, or profits of property and the fees, charges, accounts or other payments for the use or occupancy of rooms and other public facilities in hotels, motels, or other lodging properties subject to a security interest as provided in section 552(b) of this title, whether existing before or after the commencement of a case under this title.

(b)(1) The trustee, after notice and a hearing, may use, sell, or lease, other than in the ordinary course of business, property of the estate, except that if the debtor in connection with offering a product or a service discloses to an individual a policy prohibiting the transfer of personally identifiable information about individuals to persons that are not affiliated with the debtor and if such policy is in effect on the date of the commencement of the case, then the trustee may not sell or lease personally identifiable information to any person unless—

* * *

(c)(1) If the business of the debtor is authorized to be operated under section 721, 1108, 1183, 1184, 1203, 1204, or 1304 of this title and unless the court orders otherwise, the trustee may enter into transactions, including the sale or lease of property of the estate, in the ordinary course of business, without notice or a hearing, and may use property of the estate in the ordinary course of business without notice or a hearing.

(2) The trustee may not use, sell, or lease cash collateral under paragraph (1) of this subsection unless—

(A) each entity that has an interest in such cash collateral consents; or

(B) the court, after notice and a hearing, authorizes such use, sale, or lease in accordance with the provisions of this section.

(3) Any hearing under paragraph (2)(B) of this subsection may be a preliminary hearing or may be consolidated with a hearing under subsection (e) of this section, but shall be scheduled in accordance with the needs of the debtor. If the hearing under paragraph (2)(B) of this subsection is a preliminary hearing, the court may authorize such use, sale, or lease only if there is a reasonable likelihood that the trustee will prevail at the final hearing under subsection (e) of this section. The court shall act promptly on any request for authorization under paragraph (2)(B) of this subsection.

(4) Except as provided in paragraph (2) of this subsection, the trustee shall segregate and account for any cash collateral in the trustee's possession, custody, or control.

(d) The trustee may use, sell, or lease property under subsection (b) or (c) of this section—

(1) in the case of a debtor that is a corporation or trust that is not a moneyed business, commercial corporation, or trust, only in accordance with nonbankruptcy law applicable to the transfer of property by a debtor that is such a corporation or trust; and

(2) only to the extent not inconsistent with any relief granted under subsection (c), (d), (e), or (f) of section 362.

(e) Notwithstanding any other provision of this section, at any time, on request of an entity that has an interest in property used, sold, or leased, or proposed to be used, sold, or leased, by the trustee, the court, with or without a hearing, shall prohibit or condition such use, sale, or lease as is necessary to provide adequate protection of such interest. This subsection also applies to property that is subject to any unexpired lease of personal property (to the exclusion of such property being subject to an order to grant relief from the stay under section 362).

(f) The trustee may sell property under subsection (b) or (c) of this section free and clear of any interest in such property of an entity other than the estate, only if—

(1) applicable nonbankruptcy law permits sale of such property free and clear of such interest;

(2) such entity consents;

(3) such interest is a lien and the price at which such property is to be sold is greater than the aggregate value of all liens on such property;

(4) such interest is in bona fide dispute; or

(5) such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest.

* * *

§551. Automatic preservation of avoided transfer

Any transfer avoided under section 522, 544, 545, 547, 548, 549, or 724(a) of this title, or any lien void under section 506(d) of this title, is preserved for the benefit of the estate but only with respect to property of the estate.

§724. Treatment of certain liens

(a) The trustee may avoid a lien that secures a claim of a kind specified in section 726(a)(4) of this title.

(b) Property in which the estate has an interest and that is subject to a lien that is not avoidable under this title (other than to the extent that there is a properly perfected unavoidable tax lien arising in connection with an ad valorem tax on real or personal property of the

estate) and that secures an allowed claim for a tax, or proceeds of such property, shall be distributed—

(1) first, to any holder of an allowed claim secured by a lien on such property that is not avoidable under this title and that is senior to such tax lien;

(2) second, to any holder of a claim of a kind specified in section 507(a)(1)(C) or 507(a)(2) (except that such expenses under each such section, other than claims for wages, salaries, or commissions that arise after the date of the filing of the petition, shall be limited to expenses incurred under this chapter and shall not include expenses incurred under chapter 11 of this title), 507(a)(1)(A), 507(a)(1)(B), 507(a)(3), 507(a)(4), 507(a)(5), 507(a)(6), or 507(a)(7) of this title, to the extent of the amount of such allowed tax claim that is secured by such tax lien;

(3) third, to the holder of such tax lien, to any extent that such holder's allowed tax claim that is secured by such tax lien exceeds any amount distributed under paragraph (2) of this subsection;

(4) fourth, to any holder of an allowed claim secured by a lien on such property that is not avoidable under this title and that is junior to such tax lien;

(5) fifth, to the holder of such tax lien, to the extent that such holder's allowed claim secured by such tax lien is not paid under paragraph (3) of this subsection; and

(6) sixth, to the estate.

(c) If more than one holder of a claim is entitled to distribution under a particular paragraph of subsection (b) of this section, distribution to such holders under such paragraph shall be in the same order as distribution to such holders would have been other than under this section.

(d) A statutory lien the priority of which is determined in the same manner as the priority of a tax lien under section 6323 of the Internal Revenue Code of 1986 shall be treated under subsection (b) of this section the same as if such lien were a tax lien.

(e) Before subordinating a tax lien on real or personal property of the estate, the trustee shall—

(1) exhaust the unencumbered assets of the estate; and

(2) in a manner consistent with section 506(c), recover from property securing an allowed secured claim the reasonable, necessary costs and expenses of preserving or disposing of such property.

(f) Notwithstanding the exclusion of ad valorem tax liens under this section and subject to the requirements of subsection (e), the following may be paid from property of the estate which secures a tax lien, or the proceeds of such property:

(1) Claims for wages, salaries, and commissions that are entitled to priority under section 507(a)(4).

(2) Claims for contributions to an employee benefit plan entitled to priority under section 507(a)(5).

§725. Disposition of certain property

After the commencement of a case under this chapter, but before final distribution of property of the estate under section 726 of this title, the trustee, after notice and a hearing, shall dispose of any property in which an entity other than the estate has an interest, such as a lien, and that has not been disposed of under another section of this title.

§726. Distribution of property of the estate

(a) Except as provided in section 510 of this title, property of the estate shall be distributed—

(1) first, in payment of claims of the kind specified in, and in the order specified in, section 507 of this title, proof of which is timely filed under section 501 of this title or tardily filed on or before the earlier of—

(A) the date that is 10 days after the mailing to creditors of the summary of the trustee's final report; or

(B) the date on which the trustee commences final distribution under this section;

(2) second, in payment of any allowed unsecured claim, other than a claim of a kind specified in paragraph (1), (3), or (4) of this subsection, proof of which is—

(A) timely filed under section 501(a) of this title;

(B) timely filed under section 501(b) or 501(c) of this title; or

(C) tardily filed under section 501(a) of this title, if—

(i) the creditor that holds such claim did not have notice or actual knowledge of the case in time for timely filing of a proof of such claim under section 501(a) of this title; and

(ii) proof of such claim is filed in time to permit payment of such claim;

(3) third, in payment of any allowed unsecured claim proof of which is tardily filed under section 501(a) of this title, other than a claim of the kind specified in paragraph (2)(C) of this subsection;

(4) fourth, in payment of any allowed claim, whether secured or unsecured, for any fine, penalty, or forfeiture, or for multiple, exemplary, or punitive damages, arising before the earlier of the order for relief or the appointment of a trustee, to the extent that such fine, penalty, forfeiture, or damages are not compensation for actual pecuniary loss suffered by the holder of such claim;

(5) fifth, in payment of interest at the legal rate from the date of the filing of the petition, on any claim paid under paragraph (1), (2), (3), or (4) of this subsection; and

(6) sixth, to the debtor.

(b) Payment on claims of a kind specified in paragraph (1), (2), (3), (4), (5), (6), (7), (8), (9), or (10) of section 507(a) of this title, or in paragraph (2), (3), (4), or (5) of subsection (a) of this section, shall be made pro rata among claims of the kind specified in each such particular paragraph, except that in a case that has been converted to this chapter under section 1112, 1208, or 1307 of this title, a claim allowed under section 503(b) of this title incurred under this chapter after such conversion has priority over a claim allowed under section 503(b) of this title incurred under any other chapter of this title or under this chapter before such conversion and over any expenses of a custodian superseded under section 543 of this title.

(c) Notwithstanding subsections (a) and (b) of this section, if there is property of the kind specified in section 541(a)(2) of this title, or proceeds of such property, in the estate, such property or proceeds shall be segregated from other property of the estate, and such property or proceeds and other property of the estate shall be distributed as follows:

(1) Claims allowed under section 503 of this title shall be paid either from property of the kind specified in section 541(a)(2) of this title, or from other property of the estate, as the interest of justice requires.

(2) Allowed claims, other than claims allowed under section 503 of this title, shall be paid in the order specified in subsection (a) of this section, and, with respect to claims of a kind specified in

a particular paragraph of section 507 of this title or subsection (a) of this section, in the following order and manner:

> (A) First, community claims against the debtor or the debtor's spouse shall be paid from property of the kind specified in section 541(a)(2) of this title, except to the extent that such property is solely liable for debts of the debtor.
>
> (B) Second, to the extent that community claims against the debtor are not paid under subparagraph (A) of this paragraph, such community claims shall be paid from property of the kind specified in section 541(a)(2) of this title that is solely liable for debts of the debtor.
>
> (C) Third, to the extent that all claims against the debtor including community claims against the debtor are not paid under subparagraph (A) or (B) of this paragraph such claims shall be paid from property of the estate other than property of the kind specified in section 541(a)(2) of this title.
>
> (D) Fourth, to the extent that community claims against the debtor or the debtor's spouse are not paid under subparagraph (A), (B), or (C) of this paragraph, such claims shall be paid from all remaining property of the estate.

Bankruptcy Act of 1898 (1976 ed.) (Former 11 U.S.C.)

§ 93. Proof and allowance of claims

* * *

(j) Debts owing to the United States or to any State or any subdivision thereof as a penalty or forfeiture shall not be allowed, except for the amount of the pecuniary loss sustained by the act, transaction, or proceeding out of which the penalty or forfeiture arose, with reasonable and actual costs occasioned thereby and such interest as may have accrued on the amount of such loss according to law.

* * *

§ 107. Proof and allowance of claims

* * *

(4) Where a penalty not allowable under subdivision (j) of section 93 of this title is secured by a lien, the portion of the lien securing such penalty shall not be eligible for preservation under this subdivision.

* * *

Internal Revenue Code (26 11 U.S.C.)

§6321. Lien for taxes

If any person liable to pay any tax neglects or refuses to pay the same after demand, the amount (including any interest, additional amount, addition to tax, or assessable penalty, together with any costs that may accrue in addition thereto) shall be a lien in favor of the United States upon all property and rights to property, whether real or personal, belonging to such person.

§6322. Period of lien

Unless another date is specifically fixed by law, the lien imposed by section 6321 shall arise at the time the assessment is made and shall continue until the liability for the amount so assessed (or a judgment against the taxpayer arising out of such liability) is satisfied or becomes unenforceable by reason of lapse of time.

§6323. Validity and priority against certain persons

(a) Purchasers, holders of security interests, mechanic's lienors, and judgment lien creditors

The lien imposed by section 6321 shall not be valid as against any purchaser, holder of a security interest, mechanic's lienor, or judgment lien creditor until notice thereof which meets the requirements of subsection (f) has been filed by the Secretary.

(b) Protection for certain interests even though notice filed

Even though notice of a lien imposed by section 6321 has been filed, such lien shall not be valid—

(1) Securities

With respect to a security (as defined in subsection (h)(4))—

(A) as against a purchaser of such security who at the time of purchase did not have actual notice or knowledge of the existence of such lien; and

(B) as against a holder of a security interest in such security who, at the time such interest came into existence, did not have actual notice or knowledge of the existence of such lien.

(2) Motor vehicles

With respect to a motor vehicle (as defined in subsection (h)(3)), as against a purchaser of such motor vehicle, if—

(A) at the time of the purchase such purchaser did not have actual notice or knowledge of the existence of such lien, and

(B) before the purchaser obtains such notice or knowledge, he has acquired possession of such motor vehicle and has not thereafter relinquished possession of such motor vehicle to the seller or his agent.

(3) Personal property purchased at retail

With respect to tangible personal property purchased at retail, as against a purchaser in the ordinary course of the seller's trade or business, unless at the time of such purchase such purchaser intends such purchase to (or knows such purchase will) hinder, evade, or defeat the collection of any tax under this title.

(4) Personal property purchased in casual sale

With respect to household goods, personal effects, or other tangible personal property described in section 6334(a)

purchased (not for resale) in a casual sale for less than $1,000, as against the purchaser, but only if such purchaser does not have actual notice or knowledge (A) of the existence of such lien, or (B) that this sale is one of a series of sales.

(5) Personal property subject to possessory lien

With respect to tangible personal property subject to a lien under local law securing the reasonable price of the repair or improvement of such property, as against a holder of such a lien, if such holder is, and has been, continuously in possession of such property from the time such lien arose.

(6) Real property tax and special assessment liens

With respect to real property, as against a holder of a lien upon such property, if such lien is entitled under local law to priority over security interests in such property which are prior in time, and such lien secures payment of—

(A) a tax of general application levied by any taxing authority based upon the value of such property;

(B) a special assessment imposed directly upon such property by any taxing authority, if such assessment is imposed for the purpose of defraying the cost of any public improvement; or

(C) charges for utilities or public services furnished to such property by the United States, a State or political subdivision thereof, or an instrumentality of any one or more of the foregoing.

(7) Residential property subject to a mechanic's lien for certain repairs and improvements

With respect to real property subject to a lien for repair or improvement of a personal residence (containing not more than four dwelling units) occupied by the owner of such residence, as against a mechanic's lienor, but only if the

contract price on the contract with the owner is not more than $5,000.

(8) Attorneys' liens

With respect to a judgment or other amount in settlement of a claim or of a cause of action, as against an attorney who, under local law, holds a lien upon or a contract enforcible against such judgment or amount, to the extent of his reasonable compensation for obtaining such judgment or procuring such settlement, except that this paragraph shall not apply to any judgment or amount in settlement of a claim or of a cause of action against the United States to the extent that the United States offsets such judgment or amount against any liability of the taxpayer to the United States.

(9) Certain insurance contracts

With respect to a life insurance, endowment, or annuity contract, as against the organization which is the insurer under such contract, at any time—

(A) before such organization had actual notice or knowledge of the existence of such lien;

(B) after such organization had such notice or knowledge, with respect to advances required to be made automatically to maintain such contract in force under an agreement entered into before such organization had such notice or knowledge; or

(C) after satisfaction of a levy pursuant to section 6332(b), unless and until the Secretary delivers to such organization a notice, executed after the date of such satisfaction, of the existence of such lien.

(10) Deposit-secured loans

With respect to a savings deposit, share, or other account with an institution described in section 581 or 591, to the extent of any loan made by such institution without actual notice or knowledge of the existence of such lien, as against such institution, if such loan is secured by such account.

(c) Protection for certain commercial transactions financing agreements, etc.

(1) In general

To the extent provided in this subsection, even though notice of a lien imposed by section 6321 has been filed, such lien shall not be valid with respect to a security interest which came into existence after tax lien filing but which—

* * *

(d) 45-day period for making disbursements

Even though notice of a lien imposed by section 6321 has been filed, such lien shall not be valid with respect to a security interest which came into existence after tax lien filing by reason of disbursements made before the 46th day after the date of tax lien filing, or (if earlier) before the person making such disbursements had actual notice or knowledge of tax lien filing, but only if such security interest—

(1) is in property (A) subject, at the time of tax lien filing, to the lien imposed by section 6321, and (B) covered by the terms of a written agreement entered into before tax lien filing, and

(2) is protected under local law against a judgment lien arising, as of the time of tax lien filing, out of an unsecured obligation.

(e) Priority of interest and expenses

If the lien imposed by section 6321 is not valid as against a lien or security interest, the priority of such lien or security interest shall extend to—

(1) any interest or carrying charges upon the obligation secured,

(2) the reasonable charges and expenses of an indenture trustee or agent holding the security interest for the benefit of the holder of the security interest,

(3) the reasonable expenses, including reasonable compensation for attorneys, actually incurred in collecting or enforcing the obligation secured,

(4) the reasonable costs of insuring, preserving, or repairing the property to which the lien or security interest relates,

(5) the reasonable costs of insuring payment of the obligation secured, and

(6) amounts paid to satisfy any lien on the property to which the lien or security interest relates, but only if the lien so satisfied is entitled to priority over the lien imposed by section 6321,

to the extent that, under local law, any such item has the same priority as the lien or security interest to which it relates.

* * *

STATEMENT OF RELATED CASES

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

Form 17. Statement of Related Cases Pursuant to Circuit Rule 28-2.6

Instructions for this form: http://www.ca9.uscourts.gov/forms/form17instructions.pdf

9th Cir. Case Number(s) 23-15825

The undersigned attorney or self-represented party states the following:

[ ] I am unaware of any related cases currently pending in this court.

[ ] I am unaware of any related cases currently pending in this court other than the case(s) identified in the initial brief(s) filed by the other party or parties.

[x] I am aware of one or more related cases currently pending in this court. The case number and name of each related case and its relationship to this case are:

United States v. Warfield (*In re Freeman*), No. 23-15827 (9th Cir.) raises the same issue and is currently pending before this Court.

Signature s/ Matthew S. Johnshoy Date 10/02/2023

CERTIFICATE OF COMPLIANCE

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

Form 8. Certificate of Compliance for Briefs

Instructions for this form: http://www.ca9.uscourts.gov/forms/form08instructions.pdf

9th Cir. Case Number(s) 23-15825

I am the attorney or self-represented party.

This brief contains 10,998 words, excluding the items exempted by Fed. R. App. P. 32(f). The brief's type size and typeface comply with Fed. R. App. P. 32(a)(5) and (6).

I certify that this brief *(select only one)*:

[X] complies with the word limit of Cir. R. 32-1.

[ ] is a **cross-appeal** brief and complies with the word limit of Cir. R. 28.1-1.

[ ] is an **amicus** brief and complies with the word limit of Fed. R. App. P. 29(a)(5), Cir. R. 29-2(c)(2), or Cir. R. 29-2(c)(3).

[ ] is for a **death penalty** case and complies with the word limit of Cir. R. 32-4.

[ ] complies with the longer length limit permitted by Cir. R. 32-2(b) because *(select only one)*:

[ ] it is a joint brief submitted by separately represented parties;
[ ] a party or parties are filing a single brief in response to multiple briefs; or
[ ] a party or parties are filing a single brief in response to a longer joint brief.

[ ] complies with the length limit designated by court order dated ______________.

[ ] is accompanied by a motion to file a longer brief pursuant to Cir. R. 32-2(a).

Signature s/ Matthew S. Johnshoy **Date** 10/02/2023