UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

In the Matter of: Michael A. Leite and Andrea C. Carvalho, Debtors,	No. 23-15825 D.C. No. 2:22-cv-00461-DWL U.S. District Court for Arizona Phoenix
United States of America, Appellant, v. Robert A. MacKenzie, Chapter 7 Trustee, Appellee.	

Appeal from the Final Order of the United States
District Court for the District of Arizona

Answering Brief Of Appellee

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I. STATEMENT OF JURISDICTION

The appellee agrees with the jurisdictional statement of the appellant.

II. STATEMENT OF THE ISSUE

Appellant United States of America ("IRS") first identifies the issue as "the allocation of proceeds from the sale of real property subject to tax liens that were partially avoided under 11 U.S.C. §724(a)." That statement contradicts the ruling of the district court. The district court held that the lien was avoid in its entirety. The issue is the allocation of the proceeds of a single lien that secures two debts.

The IRS also says the issue is "whether, following avoidance of a penalty lien under §724(a) the sale proceeds should be allocated pro rata...." This assertion contradicts both the facts and the ruling of the district court. The fact is that there was just one lien that secures both taxes and penalties. The district court held that the entire lien was avoidable.

III. STATEMENT OF THE CASE

The appellee provides the following corrections to the appellant's statement of the case.

A. Procedural Background

The District Court held that the single lien, that secured both taxes and penalties, was avoided in its entirety. ER-46-52.

B. Legal Framework

1. Tax liabilities and tax liens

No corrections.

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

The bankruptcy estate consists of all property identified by 11 U.S.C. §541. The property included in the estate may subsequently be reduced by, among other things, abandonment (11 U.S.C. §554), or stay relief (11 U.S.C. §362) followed

by foreclosure. The allowance of exemptions does not, however, "remove" property from the estate. Rather, the Code provides that exempt property may not be liable for certain debts. 11 U.S.C. §522(c). The Code further provides that even exempt property is liable for some debts. See, e.g., 11 U.S.C. §522(k).

Exemption is not the same as abandonment. "Removal" by exemption is an inartful misnomer that has gained traction from negligent repetition. It is contradicted by other rulings of this Court. *See, e.g., In re Jacobson*, 676 F.3d 1193 (9thCir.2012); *Wilson v. Rigby*, 909 F.3d 306 (9thCir.2018). If estate property were removed from the estate by exemption, how then would the bankruptcy court have jurisdiction over those assets to implement §522(k)?

The IRS asserts that the trustee "sought to increase the property of the estate by using §724(a)". The trustee cannot "increase" the estate. The scope of the estate is determined when the bankruptcy case is filed. 11 U.S.C. §541. The trustee cannot subsequently expand the property of the estate as defined by 11 U.S.C. §541. The trustee may, however, liquidate estate property by selling it, or the trustee may exercise the rights afforded to the trustee by the Code, such as the avoidance rights under Chapter 5 of the Code, to turn those rights into money. The trustee can increase the size of the estate's bank account, but he cannot increase the property of the estate.

If a lien is avoided, and if that lien is preserved for the benefit of the estate under 11 U.S.C. §551, that avoided lien is also part of the estate. 11 U.S.C. §541(a)(4). The trustee's right to avoid liens arose when the case was filed, not subsequently. The exercise of these rights does not "increase" the estate.

Contrary to the appellant's assertion, the district court held that the entire lien was avoided, not just the "penalty portion". ER-46-52. That is consistent with the Code which, as the IRS acknowledges, permits the trustee to avoid a lien that

secures a claim of a kind specified in section 726(a)(4) of this title.

The assertion of the IRS that §724(a) allows "the trustee to avoid the portion of a lien" that secures penalties is contrary to the plain language of the Code, and contrary to the holding of the district court.

C. Factual background

The appellee provides the following supplement to the statement of facts offered by the IRS:

1. Prior to filing the adversary out of which this dispute arises, the trustee pulled the laboring oar to create the fund of money that is in dispute. In particular, the trustee took the actions necessary to oppose stay relief by the first lien holder and to sell the real estate which produced the $38,642.80 which is at issue. ER-183-187 (Dkt. Nos. 23, 26, 27, 30, 39, 40, 63); ER-7.

2. The trustee's efforts in consummating a sale of the property not only paid in full the first lien holder, thereby preventing the house from being lost to foreclosure, it left excess proceeds of $38,642.80, money that would not have been available had the property been foreclosed by the first lien holder. Id.

IV. SUMMARY OF THE ARGUMENT

The IRS describes the trustee's exercise of the rights afforded by Congress under §724(a) as a "windfall for unsecured creditors at the expense of the public fisc." Brief For The Appellant ("OB"), p. 19. However, the IRS has never provided any evidence of any harm to the fisc. On the contrary, this case is a poster child for why that assertion is nearly as specious as it is offensive.

In this case, the trustee rescued a house from foreclosure, sold it, and now the trustee has money to pay to the IRS for the benefit of the "fisc". Had Congress not incentivized the trustee to act, this house would have been lost to a foreclosure by the first lien holder and the IRS (who was blissfully asleep at the

wheel) would have received nothing. Instead, the IRS now stands to receive a healthy check without spending so much as one thin dime (except for the money the IRS has spent trying to keep the estate from receiving anything). The windfall is to the fisc, not to the unsecured creditors.

Moreover, §724(a) is not just about taxes. A lien avoidable under §724(a) can be any lien that secures penalties. The "fisc" is not singled out by the avoidance rights bestowed by Congress, and those rights should not be curtailed simply to satisfy the endless appetite of the fisc.

V. ARGUMENT

A. Introduction

This appeal is one of three related appeals prosecuted by the IRS. In these appeals, the IRS seeks to eviscerate §724(a) so that it will never again be used for the benefit of the unsecured creditors in a bankruptcy case.

In this case and in *United States v. Warfield*, No. 23-15827, the IRS seeks to obtain rulings that amend §724(a) to add a "tax first" requirement that the Code does not contain. If successful, then §724(a) will likely never be used again since the principal debt that is secured by a lien almost always exceeds the penalty debt. If the principal debt must be paid first, then more often than not there will be nothing left to pay on the penalties. As a result, no trustee (or debtor-in-possession) will have any incentive to seek avoidance under §724(a). And, while the IRS only seeks relief with regard to taxes and interest, if successful any lien that secures both principal and penalties will be subject to the same limitations.

In the third appeal, *United States v. Warfield ("Tillman"),* No. 21-16034, the IRS has already accomplished part of its goal. In that case, the IRS persuaded two members of this Court that the trustee could not avoid a lien under §724(a) if the debtor claimed an exemption in the property that was subject to an avoidable lien.

That, of course, is the situation with the vast majority of individual bankruptcy cases. As a result, the bankruptcy estate can no longer exercise the rights afforded by Congress under §724(a) in most individual bankruptcies, since §724(a) now has an "exempt property" exception that Congress did not include in the plain language of the statute. If the IRS can also add a "tax first" or "principal first" exception to §724(a), then §724(a) will become a useless appendage. The trustee is in the process of drafting a petition to the United States Supreme Court to review the *Tillman* decision.

The arguments raised by the IRS are the same arguments that it made to the district court. The district court addressed and rejected each one. The IRS has not demonstrated why the district court was wrong.

B. The Arguments Were Rejected By The District Court.

District Judge Lanza in the MacKenzie (Leite) case (2021 WL 4427069) and District Judge Humetewa in the Warfield (Freeman) case (2023 WL 2665735) case each wrote lengthy, detailed and well supported opinions. Those opinions explain step by step why each of the positions taken by the IRS are not meritorious.

The IRS does not demonstrate to this Court where either Judge Lanza or Judge Humetewa went astray, either on the facts or the law. Rather, the IRS brief is simply a "do over" of the same arguments that it made before.

Since the trustee cannot improve on the rulings of Judge Lanza or Judge Humetewa, the trustee incorporates them by reference herein. For the reasons and authorities cited by Judge Lanza and Judge Humetewa, this Court should affirm those rulings.

C. There Is No Windfall

The IRS asserts that allocating funds obtained pursuant to an avoided lien between the principal and the penalties, both of which are secured by the same

lien, "creates a windfall for unsecured creditors by improperly increasing the estate at the expense of secured creditors." OB, p. 23.

First, Congress is the one who decided that penalties that are secured by liens on estate property should be paid to unsecured creditors. The IRS does not get to second guess Congress just because the IRS disagrees with the Congressional policy choice.

Second, there is no evidence in this record or any other record of a "windfall". On the contrary, the evidence in this case shows that the trustee pulled a rabbit out of his hat for the IRS. Even with pro-rata allocation of the net sale proceeds, the lion's share of the money recovered by the trustee will go to the IRS. While the trustee toiled in the field, the IRS lounged on the porch. The only one enjoying a windfall here is the IRS.

Third, §724(b) allows the proceeds of a tax lien that is NOT avoidable to be used to pay certain priority claims. If §724(a) is a windfall to unsecured creditors, how is §724(b) any less of a windfall to priority claimants? It too comes at the expense of the "public fisc". But, there it is, in black and white. The assertion that pro rata allocation of the proceeds cannot be allowed simply because it is alleged by the IRS to be a "windfall" means that §724(b) cannot be allowed either.

Congress made a policy decision in §724 about how the proceeds of certain liens were to be distributed. The IRS doesn't like those policy decisions. The remedy the IRS seeks can only be found on Capitol Hill, not in this Court.

D. Secured Creditors Are Not Always Paid First.

The IRS argues *ad naseum* that "secured creditors must be paid first from their collateral." OB, p. 20. The IRS is wrong.

Secured creditors are not always paid "first". As noted above, §724(b) is a Code based exception to this axiom. Similarly, 11 U.S.C. 506(c) permits the

bankruptcy court to "surcharge" the collateral of secured creditors. Thus, the assertion that secured creditors must *always* be paid first is simply wrong.

Also, secured creditors who held avoided liens are not paid first. A secured creditor whose lien is avoided under any of the avoidance rights in Chapter 5 of the Code is not paid "first". On the contrary, the proceeds of the collateral goes to the unsecured creditors, since the lien, once avoided, is preserved for the benefit of the estate. 11 U.S.C. §551. Or, as the IRS calls it, a windfall.

Avoidance under §724(a) is no different. The value of the collateral is paid to the "secured creditor". But, when the lien is avoided and preserved for the estate under §551, the bankruptcy estate succeeds to the rights of the creditor and the estate is paid in the place of the creditor. The "secured creditor" is paid first - but the secured creditor is no longer the original creditor. It is the estate, standing in the shoes of the original creditor.

E. The IRS Holds The Jailhouse Keys

Since the IRS wants this to be about fairness and windfalls, let's not forget how we got here.

No one has ever required the IRS to file one lien that secures BOTH taxes and penalties. The IRS could avoid the problem about which it complains to this Court by simply recording two separate liens - a first lien for the taxes and a second lien for the penalties. By doing so, the first recorded lien, for just the taxes, would always be paid prior to the junior lien for the penalties.

Or, the IRS could simply not record a lien for the penalties at all. Then the IRS would never be in jeopardy of having a lien avoided under §724(a).

If the IRS finds this "windfall" to be unfair, the IRS can prevent it from happening. Until then, the IRS subjects its liens to avoidance by including penalties and taxes in the same lien.

This is also the answer to the "absurd result" posited by the IRS at OB, pp. 32-33. If the IRS does not wish to share the proceeds of its tax liens with penalties, then the IRS simply needs to avoid recording one lien that secures both.

The same is true for private secured creditors. No one forces any creditor to take a lien in the first place, nor to take one lien that secures all obligations. But, when one lien secures multiple debts, then the proceeds of the collateral must be allocated between the debts which are secured.

When there is but one beneficiary of a lien, that beneficiary can make the decision about how to allocate the proceeds of liquidated collateral. But, when the beneficial ownership of the lien is bifurcated, then there must be an allocation of the payments on the debt.

Take a mortgagee as the IRS hypothesizes at OB p. 34. A mortgage or deed of trust perfects a lien on some collateral to secure payment of an underlying debt. Typically that debt is memorialized by a promissory note. And, more often than not, the promissory note specifies the order in which payments received on the note are applied. Those provisions provide a means to allocate the proceeds of the collateral.

But, here, there is no underlying instrument or agreement that directs the allocation of the proceeds of the collateral. The IRS points this Court to nothing about either the lien, or the underlying assessment of the taxes or the penalties, that give one priority over the other when a payment is made on the lien.

The IRS does make this bald assertion: "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." OB p. 21. The IRS misses the point.

If we assume for the sake of argument that the taxes here were assessed before the penalties (facts not in evidence in this case) the IRS ignores the fact that

BOTH debts were secured at *exactly the same instant* when the lien was recorded. Thus, regardless of which debt existed first, both became secured debts at the same time, and neither one has priority over the other.

When a debt is created does not determine its priority if both debts are secured debts. A debt incurred in 2020 that is not secured until 2023 does not enjoy priority over a debt that is incurred in 2021 that is secured in 2022. First in time is first in right. *U.S. by and through I.R.S. v. McDermott*, 507 US 447 (1993).

Second, there is no statute nor rule, nor any agreement between the taxpayers and the IRS, that provides for the payment of the taxes before the penalties or vice versa. If there were, surely the IRS would have cited that statute, rule or agreement to this Court in its 64 page dissertation. That authority is conspicuously absent.

Once again, the IRS turns to speculation and conjecture to gain sympathy from the Court. At OB p. 35, the IRS asserts paying the taxes that are secured by the same lien as the penalties "substantially diminishe[s] the efficacy of federal tax liens." Yet, not surprisingly, the IRS offers no evidence to support that assertion. After all, given the paucity of case law, this is clearly not an issue that comes before the bankruptcy court with any frequency. The larger burden on the "fisc" comes not from the trustee's exercise of the rights afforded by §724(a), but from the revenue expended by the IRS in fighting it, and in consuming the resources of the courts. These sorts of avoidance actions are as scarce as hen's teeth, yet the IRS is litigating §724 as if the Internal Revenue Code had been found to be unconstitutional. Surely if there is such a huge impact on the fisc the IRS can persuade Congress to plug the hole in the bucket.

F. §724 Should Not Be Judicially Amended Again

The IRS recently persuaded two members of this Court that §724(a) does

not allow the avoidance of penalty liens that have attached to property in which the debtor has asserted an exemption. *In re Tillman*, 53 F4th 1160 (9thCir.2022).[1] The effect of that ruling is to amend §724 to add an "except for exempt property" exception that does not exist in the Code.

Circuit Judge Bumatay, in his dissent at p. 1176, cogently explained the error in doing so:

> In invalidating the trustee's avoidance authority, the majority is more concerned with the Bankruptcy Code's "troubling result" than its text. Maj. Op. at 24. It lets concerns over the consequences of avoidance override the statutory text and it nullifies the trustee's avoidance power to prevent these consequences. But because our duty is to follow the text of the Bankruptcy Code no matter how the pie gets sliced, I respectfully dissent.

Just as there is no exception in §724 for estate property in which an exemption is asserted by the debtor, there is no "tax first" exception in §724 either. Rather, the IRS simply wants this Court to add such an exception to prevent the "windfall" fiction conjured up by the IRS.

And, once again, this is not just about the "fisc". The ruling of this Court in this case affects any kind of penalty lien, not just penalties that are part of a tax lien. If this Court takes the bait offered by the IRS, a judgment lien with a treble damages penalty will be, in most instances, valueless to the estate since the damages

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[1] The court found that the exemption "removed" the property from the estate, thereby preventing avoidance. The concept that exempt property is "removed" from the estate by the allowance of an exemption is contradicted by the Code itself. See, 11 U.S.C. §522(k).

will be paid ahead of the penalties. In effect, the penalties, which Congress decided to allocate to the estate for the benefit of the unsecured creditors, would be subordinated simply by the trustee's exercise of the Congressionally afforded avoidance rights. The trustee will have no incentive to see avoidance in the first place. By adding a "tax first" or "principal first" exception to §724, §724 becomes radioactive - as soon as the trustee opens the lead box he loses.

G. Hutchinson Is Not Supported By The Bankruptcy Code

At OB p. 36, the IRS points this Court to a decision from the California bankruptcy court, *In re Hutchinson ("Hutchinson 2")*, 2022 WL 1021843 (Bankr.E.D.Ca.). In that case, the IRS successfully persuaded the bankruptcy court (the Hon. Jennifer E. Niemann presiding) that the taxes should be paid before the penalties.

Hutchinson 2 buys into the "harm" argument offered by the IRS. At p. *4 of *Hutchinson 2*, the court says that the "penalty portion of the lien is subordinated to the tax and interest portions." Where does §724(a) say such a thing? It doesn't. On the contrary, §724(a) says that the "lien" can be avoided and §551 (which specifically references §724(a)) says that, once avoided, the lien is preserved for the estate. The word "subordinated" appears nowhere in either statute.

The *Hutchinson* 2 court comes to its conclusion by swallowing another IRS herring, §726(a)(4). The problem, however, is that §726(a)(4) addresses the trustee's distribution of property of the estate: "except as provided in section 510 of this title, property of the estate shall be distributed-". §726(a). §726 has nothing to do with the payment that must be made on a lien.

§726 does not address how the holders of a lien, i.e., secured creditors, are to be paid. In fact, §726 make no provision at all for the payment of secured creditors.

The IRS repeatedly asserts that secured creditors must be "paid first". OB, p. 37. Yet, §726 says nothing about paying secured creditors. Does that mean that secured creditors don't get paid since they are not provided for in §726? Of course not. That would turn the bankruptcy world on its head.

The trustee's avoidance of a lien under §724 (or under §§544, 547, 548, or 549) are not "distributions of estate property". The distribution of estate property does not happen until AFTER the trustee (a) avoids the lien, (b) liquidates the collateral and (c) pays the secured lien holders. Then, and only then does the trustee begin the process of doling out the remaining money to the unsecured creditors pursuant to §726. If there are unavoidable liens on the collateral, they must be paid (subject to certain exceptions). But, when there is an avoided lien, the proceeds of that lien are paid to the trustee who then holds those funds for the benefit of the estate until a distribution is subsequently made in accordance with §726.

The analysis of the IRS, and the *Hutchinson 2* court, skips the payment of the secured debts and tries, wrongfully, to import §726 into the lien payment process long before any distribution of estate property occurs. As Judge Humetewa put it, "the priority allocation method is not grounded in any *applicable* provision of the Code." (emphasis in original) *Freeman*, *supra*, 2023 WL 2665735, *10. She hit the nail on the head. Judge Lanza also explained why the position advocated by the IRS, and accepted by *Hutchinson 2*, was wrong:

> Second, the government's interpretation would also create disharmony with other provisions of the Bankruptcy Code, such as §§ 551, 724(a), and 726. The government argues that, once the Trustee avoided the avoidable portion of the Tax Lien, the distribution scheme in § 724(b) put the Trustee's new claim to the avoided-and-preserved lien at

the bottom (i.e., § 724(b)(6)). (Doc. 7 at 20.) But subordinating the avoided portion of the lien would be inconsistent with the Bankruptcy Code. Once a lien is avoided under § 726(a)(4) (as the Penalties were), it is automatically preserved for the benefit of the estate. 11 U.S.C. § 551; IRS v. Baldiga (In re Hannon), 619 B.R. 524, 533-34 (D. Mass. 2020). When a lien is avoided and preserved, the Trustee steps into the shoes of the former lienholder and receives all of the former lienholder's rights and priority. Haberman, 516 F.3d at 1210 ("[T]he trustee, on behalf of the entire estate, assumes the original lienholder's position in the line of secured creditors; in this way, Congress sought to assure that the avoidance of a lien doesn't simply benefit junior lienholders who would otherwise gain an improved security position and might, when the estate is limited, prove the only beneficiaries of the trustee's actions."); In re Van de Kamp's Dutch Bakeries, 908 F.2d 517, 519 (9th Cir. 1990) (noting the "well-established principle that a trustee who avoids an interest succeeds to the priority that interest enjoyed over competing interests"). In other words, the Trustee occupies the same place in line as the original lienholder. To displace the Trustee's priority, as the government urges, would be inconsistent with the nature of preservation.8

Third, displacing the Trustee's priority would also be

inconsistent with § 724(b)'s distribution scheme itself. "[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...." In re Darnell, 834 F.2d 1263, 1265 (6th Cir. 1987). Section 724 "sets forth an exception to the general rule that priority claims do not affect perfected secured claims." Id. at 1266. Courts have interpreted § 724(b) as subordinating tax liens but leaving the priority of other specified liens otherwise undisturbed. Id. at 1267 ("The legislative history clarifies that the result of these subsections [is] to leave senior and junior lienors and holders of unsecured claims undisturbed.") (cleaned up); In re Navis Realty, Inc., 193 B.R. 998, 1004 (Bankr. E.D.N.Y. 1996) (same); 6 Collier ¶ 724.03[5d] (noting that § 724(b) "has no effect on liens that are junior or senior to a tax lien" but instead "adjusts distributions between the holders of tax liens and priority claims, without affecting other lienholders"). Adopting the government's position would essentially take the Trustee's priority, in the shoes of the original lienholder, and turn it on its head, requiring all other junior liens and secured claims to be satisfied first. Darnell, 834 F.2d at 1268-69 ("Under § 724, property is not distributed to the estate (§ 724(b)(6)) until all liens, both tax and nontax, are satisfied.... [B]y its terms, property distributed under [§

724] does not become part of the estate unless or until all secured claims have been satisfied.").

MacKenzie, supra, 2021 WL 4427069, *9.

Other than this ruling from the bankruptcy court in *Hutchinson 2*, the IRS has never persuaded any other court that the IRS is right on this issue. See, *U.S. v. Hutchinson ("Hutchinson 1")*, 615 B.R. 596, 602 (E.D.Cal.2020)[2] and *Internal Revenue Service v. Baldiga (In re Hannon)*, 619 B.R. 524 (D.Mass.2020)[3].

In *Hutchinson 1*, the issue before the district court was the same as the issue before this Court: "Here, the question is whether the tax and interest portions of the IRS's five liens enjoy a higher priority over the penalty portions of the liens, despite each lien being comprised of tax, interest, and penalties at recordation." The district court's answer: No. The district court rejected the government's arguments, finding that the preservation of the penalties for the benefit of the unsecured creditors was consistent with the Code, even though that "may nonetheless result in a distribution order that in essence elevates junior creditors over the priority of the IRS." *Id*. at 605-606.

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[2] After losing an application for abandonment in the bankruptcy court and the district court, the IRS appealed to the 9th Circuit. But, the IRS later filed a motion to dismiss its own appeal on the grounds that it was moot. While the 9th Circuit granted that motion, and vacated the district court's ruling, 2020 WL 5588598 (9th Cir. 2020), the fact remains that the district court ruled squarely against the IRS and the 9th Circuit did not overturn that ruling on the merits. According to the district court order which appeared in the Hutchinson bankruptcy case on December 9, 2020 at Dkt. No. 136, the parties had settled without advising the district court. The presiding Judge in *Hutchinson 1* was the Hon. Frederick E. Clement. Subsequently, in *Hutchinson 2*, the new presiding judge, the Hon. Jennifer E. Niemann, changed course and sided with the IRS, undeterred by the district court ruling.

[3] The IRS appealed the ruling to the 1st Circuit on September 22, 2020. Case No. 20-1884, and then dismissed the appeal. 2020 WL 9171284.

The IRS lost this same issue in *Internal Revenue Service v. Baldiga* (*In re Hannon*), 2020 WL 4015775 (D.Md.July 16, 2020). While the IRS characterized the district court's ruling as a suggestion that a preserved lien for penalties could participate under §724(b), the district court's ruling was more than just a suggestion:

> On its face, the IRS's argument is enticing. Even a cursory reading of §§724(a) and (b), 726 and 551, however, reveals an inherent flaw. By avoiding the penalty and interest on penalty portions of the IRS liens, those funds are no longer "not avoidable" and, therefore, not subject to §724(b). The relevant provisions, as discussed above, make clear that distributing funds from an estate to compensate the IRS for a tax penalty rather than preserving such funds for the unsecured creditors is disfavored because such a penalty does not reflect "damages for actual pecuniary loss suffered by the [IRS]." §726. That is the reason §724(a) provides for the avoidance of the penalty portion of a lien for the benefit of the estate and not for the benefit of holders of later recorded liens. See *In re Hutchinson*, 2020 WL 2112275, at *8.

Id. at *7.

In each case the IRS made the same arguments - that the taxes secured by the liens must be paid ahead of the penalties even though both are secured by the same lien. That argument failed in those cases. The fact that multiple liens were involved is simply irrelevant. The same legal reasoning applies to one lien or ten liens. The IRS cannot seriously expect this Court to find that §§724(a) and (b) operate differently if there is just one lien without enough money to pay it in full

instead of multiple liens without enough money to pay them in full. That argument is less than a stone's throw from specious.

In short, the arguments of the IRS have been rejected by every other court to consider the issue save one. Those same arguments are no better now than they were then, and there is no way to distinguish the legal reasoning in those matters from the cases now before this Court.

The IRS has also argued that Congress did not want an avoidable lien to trump a not-avoidable lien for tax. While Congress could have subordinated the avoidable lien to a non-avoidable tax lien, the Code contains no such subordination.

The bottom line is that the assertion of the IRS, that the lien for the tax somehow comes ahead of the lien for the penalties, when they are secured by the same lien, is an argument that no other court has found to be valid. And, if it were, such a ruling would result in a *de facto* amendment of §724(a) to provide that penalty liens, even if avoided, can only be paid after the taxes secured by the same lien are paid in full. The Code doesn't say that, and such an amendment is for Congress if Congress sees fit. The efforts of the IRS to spin that conclusion from straw are unavailing.

The IRS has complained that it would be better off if it never secured the penalties at issue with a lien in the first place. That may be true. But, that is a policy decision that the IRS has to make. Does the risk of having a bankruptcy trustee avoid and take over a penalty lien outweigh the benefit of taking the lien in the first place? Likely not. The IRS is probably paid the full amount of its lien from voluntary real estate sales 100,000 more times than some bankruptcy trustee avoids a penalty lien. But, if the IRS wants to stop securing penalties for fear that some bankruptcy trustee may someday seek to avoid the lien, that is for the IRS to decide. Either that or the IRS can go to the Hill and ask Congress to remove, or amend, §724(a). Until then,

the bankruptcy estate is entitled to the proceeds of the tax lien to the extent of the penalties, and the penalties must be paid on par with the taxes and interest, since both are secured by the same lien.

H. §725 Is Inapposite

The IRS continues to try and hang its hat on 11 U.S.C. §725, arguing that it is "the provision that most embodies the special status of secured creditors." OB, p. 39. The IRS contends also at p. 39 that "Section 725 ensures that entities other than the estate will have their interests satisfied before any excess proceeds go to the estate."

Not surprisingly, the statute says no such thing. There is no mention of "excess proceeds". No what the statute says is that "before final distribution" of the estate, the trustee "shall dispose" of property in which an entity other than the estate has an interest. Here, the trustee is holding the entirety of the sale proceeds. He has every intention of paying the appropriate share of that money to the IRS once this Court rules, in full compliance with the Code. But, arguing that §725 requires the trustee to give the IRS all of the sale proceeds finds no footing in the plain language of that statute.

§725 doesn't discuss taxes, or avoidable or unavoidable liens. It simply directs the Chapter 7 trustee to dispose of "any property in which an entity other than the estate has an interest" that has not already been disposed of during the administration of the case. The legislative history for that little used Code section says that the purpose of that section "is to give the court appropriate authority to ensure that collateral or its proceeds is returned to the proper secured creditor". *In re Aspen Data Graphics*, *Inc.,* 109 B.R. 677 (Bankr.E.D.Pa.1990). Here, the avoided lien is preserved for the benefit of the estate. 11 U.S.C. §551. The proceeds of the

lien will be paid to the holders of the lien, which are the IRS AND the bankruptcy estate. Once the estate has its share, those funds will be distributed pursuant to 11 U.S.C. §726.

I. It's Not Your Lien Anymore

Much of the argument presented by the IRS is premised on the misconception that the IRS alone gets to decide what happens with the tax lien and the debts that it secures.

The legal flaw in that reasoning is simple: Once the lien is avoided, and preserved for the estate, the lien does not belong to the IRS any more. Part of the debt secured by that lien, the penalties, must now be paid to the trustee. Thus, it is not up to the IRS to decide how the proceeds of the lien are allocated.

The IRS apparently does not understand (or want to accept) the concept of lien avoidance. When a lien is avoided, the trustee stands in the shoes of the creditor with respect to the avoided lien and is equitably subrogated to the creditor's rights. *In re Wyatt*, 440 B.R. 204, 213 (Bankr.D.Colum.2010) ("[The trustee] White is deemed to have been in the shoes of Wachovia with respect to its in rem lien rights and its proceeds are treated as property of the estate.")

The problem here is that the tax lien (like many tax liens) secures two debts. Thus, the question is how to allocate the collateral (the sale proceeds of the property) between that portion of the debt that is still owed to the IRS and the portion that is now owed to the bankruptcy estate for the benefit of creditors.

Equity recognizes that, where there is one fund of money to be divided among equal claimants, the distribution of that fund should be on a *pro rata* basis. *See, In re Centergas*, 172 B.R. 844, 853 (Bankr.N.D.Tex.1994); *In re National Century Financial Enterprises, Inc.*, 2005 WL 6242169, *10 (Bankr.S.D.Oh.). That

is this case - there is a fund of money from the sale, $38,643.80 which is subject to a single lien, and there are two parties with equal rights to the proceeds of that lien. Accordingly, that fund must be pro-rated between the parties who hold the rights under the lien

The remedy for avoided transfers, including transfers avoided under §724(a), is found in 11 U.S.C. §550(a). §550 is an equitable remedy and the Court is permitted, within its discretion, to fashion a remedy consistent with the purpose of making the bankruptcy estate whole. *See, e.g., In re Straightline Investments, Inc.*, 525 F.3d 870, 885 (9th Cir. 2008). The purpose of 11 U.S.C. §550 is "to restore the estate to the position it would have occupied had the property not been transferred." *In re Brun*, 360 B.R. 669, 674-675 (Bankr. C.D. Cal. 2007); *see also*, *In re Taylor*, 599 F.3d 880, 890 (9th Cir. 2010); *In re Seitz*, 400 B.R. 707, 722 (Bankr. E.D. Mo. 2008); *In re Hang*, 2007 WL 2344958 (Bankr. E.D. Cal. 2007).

Here, if the all of the sale proceeds are allocated to the taxes and interest, then §724(a) is eviscerated. There will rarely be situations where there is more money than the tax and the interest on the tax. The penalties will never be paid, even though Congress saw fit to make the penalties available to the unsecured creditors. Adding a "tax first" exception to §724 is unwarranted.

The court has the authority to determine how the proceeds of a tax lien are allocated when the debt is undersecured. For example, in *U.S. v. Specialty Cartage*, 113 B.R. 484 (D.N.Ind. 1990), the IRS wanted to apply the proceeds of the lien first to the penalties, the exact opposite of what the IRS wants to do here! The district court upheld the bankruptcy court's decision to apply the proceeds to the tax first, noting that, "The bankruptcy court must have the authority to make allocation decisions in the best interest of the plan of reorganization."

The only case cited by the IRS which supports the "tax first" position

advocated by the IRS is *In re Seneca Balance, Inc.*, 114 B.R. 378 (Bankr.W.D.N.Y.1990). But, *Seneca Balance* was decided before the Supreme Court's ruling in *U.S. v. Energy Resources, Inc., 495 U.S. 545 (1990), affirming In re Energy Resources Co, Inc.*, 871 F.2d 223, 230 (1st Cir.1989), in which the Supreme Court held that the bankruptcy court had the authority to determine how tax payments are to be applied. Moreover, *Seneca Balance* did not involve a lien that had been avoided under §724(a). While the IRS may apply its portion of the lien proceeds as it wishes, there is no basis to apply the estate's portion as dictated by the IRS. *Seneca Balance* is not premised on any rule or statute, and it fails to take into consideration the rights afforded to the bankruptcy estate 11 U.S.C. §724(a). The "tax first" theory adopted by *Seneca Balance* defeats the Congressional decision to make tax penalties available to the unsecured creditors of the bankruptcy estate.

J. Pro Rata Allocation Does Not Violate §724

The next contention of the IRS is that pro rata allocation violates §724. It does not.

First, §724 contains no mechanism for distributing funds on a single lien that secures two debts which are owed to different parties. Since the trustee steps into the shoes of the IRS with respect to the penalties, and since the penalties were secured at exactly the same time as the taxes, both debts are entitled to equal payment. Whether that is accomplished pursuant to 11 U.S.C. §105 or 11 U.S.C. §550 does no violence to §724.

Second, pro rata allocation does not violate the asserted "bankruptcy principle that secured creditors should be paid first from their collateral". Once again, the IRS chooses to ignore the fact that the bankruptcy estate has succeeded to the lien rights of the IRS under the lien and is now just as much of a secured creditor as the IRS. As long as the IRS continues to adopt the ostrich position on that

fundamental concept, the IRS will continue to go astray.

The IRS also argues that the taxes and the penalties are "not on equal footing". While they are certainly different debts, the IRS chose to secure both of them at the same time with the same lien. As a result, they are in fact on equal footing. This is not a matter of putting unsecured creditors ahead of secured creditors. Both debts are secured debts. Both are secured by the same lien.

Whether the liability for the tax debt preceded the liability for the penalty debt is similarly irrelevant. A bank could secure two loans, loans which were made on different dates, with a single mortgage or deed of trust. Those debts would both become secured debts at the instant the mortgage/deed of trust is recorded. The fact that one debt was incurred before the other would not give one priority over the other. This single tax lien which secures three debts (taxes, interest and penalties) is no different. Furthermore, the government's own lien, ER-134, does not reflect separate assessment dates for the taxes and the penalties. Thus, there is no evidence in the record before this Court that one debt became a legal obligation of the taxpayers ahead of the other.

Furthermore, even if we assume for the sake of argument that the tax liability was somehow incurred before the penalties, the same cannot be said of the interest on the tax. The interest on the tax would accrue over time as the taxes remain unpaid. Yet, the IRS chooses to ignore that obvious flaw in its own argument. If the date that the debt is incurred determines when it gets paid, then the interest is behind the penalties.

K. Complete Or Partial Avoidance Leads To The Same Result

The IRS complains that the district courts erred in finding that the entire lien was avoided. However, whether the lien is avoided entirely or partially leads to the same result.

If the lien is avoided entirely, then the estate holds a single lien which secures two debts, and both debts have to paid from the same collateral. If the lien is avoided partially, then the estate holds the lien to the extent of the penalty debt, and the IRS holds the lien to the extent of the tax/interest debt. Once again, both debts have to paid from the same collateral. Either way there has to be an allocation of the proceeds of the collateral between the two debts.

The reliance on *Official Creditors Comm. Of Suffolla, Inc. v. U.S. Nat'l Bank of Oregon (In re Suffolla, Inc.)*, 2 F.3d 977, 982 (9thCir.1993) and similar citations for the proposition that an avoidable lien can be broken into pieces is misplaced. *Suffola* discussed the remedial effect of avoidance on transfers under §550(a) , not the avoidance of liens under §724(a): "The 'to the extent that' language simply recognizes that transfers sometimes may be avoided only in part, and that only the avoided portion of a transfer is recoverable."

Here, there is but one lien that secures two debts. That one lien is avoidable under the plain language of §724(a) ("The trustee may avoid a lien", not a lien "to the extent"). But, because that single lien secures two debts, only the penalty portion is now "recoverable" by the estate for the benefit of creditors. The remainder is payable to the IRS and is not recoverable by the estate.

L. The IRS Logic Leads To Preposterous Results

At the end of the day, what the IRS wants this Court to rule is that the IRS lien for the taxes it is owed is somehow superior to the lien for the penalties that it was owed, even though they are secured by the same lien. How can that be? There is but one lien which secures two debts. How can one suddenly become superior to the other just because the trustee is authorized to avoid and collect part of that lien under §724(a)?

The IRS cannot point this Court to any Code provision that makes the

debt that the IRS holds superior to the debt that the trustee holds under the very same lien. There are two debts, but just one lien. One debt is not superior to the other. One debt does not become superior to the other only after avoidance.

Consider the implications of the twisted logic of the IRS. Assume for example that an avoidable penalty lien is recorded on January 1, 2020. Subsequently, a non-penalty lien is recorded on January 1, 2021. A year later, on January 1, 2022, a bankruptcy is filed.

Not even the IRS could seriously argue that the penalty lien is not avoidable - §724(a) makes it clear that it is. But, following the logic of the IRS, the subsequent lien, recorded a year later on January 1, 2021 would leapfrog the January 1, 2020 lien once avoided by the trustee, despite the plain language of 11 U.S.C. §551. After all, argues the IRS, paying the avoided penalty lien first "undercuts" the non-penalty lien, or "underpays" the non-avoidable lien. Of course it does, but that's how the Code is structured. It is not, as the IRS contends, inconsistent with the Code. It is not, as the IRS contends, a windfall.

The IRS complains incessantly that liens must be honored. But, apparently the IRS feels for some reason that only part of a lien, the tax part, is entitled to protection. The notion that the penalty portion, once avoided by the trustee, is somehow subordinated to the tax portion, and entitled to lesser protection, is without any legal basis.

The IRS also complains that allocating the funds pro rata underpays the tax. Well, it also underpays the penalties, which are entitled to the same priority as the tax, since they are secured by the very same lien. Once again, the conclusion of the IRS that somehow the taxes are superior to the penalties when both debts are secured by the very same lien is unsupportable.

Likewise, the IRS says that "secured claims first" is the proper approach.

What does the IRS think the penalties are? Unsecured? The penalties are just as much a secured claim as the taxes. It is just that the trustee now holds the secured claim for the penalties. The lien that secures the penalties does not evaporate when the trustee avoids it. No, the trustee takes over the rights of the lien holder.

M. The Remaining Arguments Are Not Meritorious

The government has spilled considerable ink on this finite issue. This matter was fully briefed in the bankruptcy court and the district court. Judge Humetewa issued a 21 page opinion United States v. Warfield and Judge Lanza issued a 14 page opinion in this case. The government's opening brief here is a mind numbing 53 pages of text.

The trustee has not responded to each and every contention or case citation offered by the IRS, and will no doubt hear how those arguments are "uncontested". They are not. The point comes, however, when the matter has been sufficiently briefed. The district court opinions are comprehensive and detailed, and the IRS has offered nothing new. So, while the trustee concedes nothing, whatever remains has been adequately addressed, or is unworthy of further briefing.

VI. CONCLUSION

Wherefore, the trustee prays that this Court will affirm the decision of the district court.

DATED: October 24, 2023.

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CERTIFICATE OF SERVICE

I hereby certify that on October 24, 2023 I electronically transmitted the foregoing document to the Clerk's Office using the ECF system for filing, and transmitted a copy of the filed document to the following ECF registrants:

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/s/ Terry A. Dake

STATEMENT OF RELATED CASES

The undersigned certifies that the following are known related cases and appeals:

United States v. Warfield, No. 21-16034

United States v. Warfield, No. 23-15827

DATED October 24, 2023.

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CERTIFICATE OF COMPLIANCE

I am the attorney or self-represented party. This brief contains 8436 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)*:

__xx_ complies with the word limit of Cir. R. 32-1.

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_____ a party or parties are filing a single brief in response to a longer joint brief.

DATED October 24, 2023.

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