PROCEDURAL RECOMMENDATIONS TO THE BANKRUPTCY CODE

The Bankruptcy Code contains numerous procedures governing the treatment and status of claims by and against the estate. The procedural treatment for two types of these claims is addressed in the following section. First, preference claims by the estate are designed to recover certain payments or other transfers of property within ninety days of the commencement of a case under the Bankruptcy Code. Preventing debtors from "preferring" certain creditors on the eve of bankruptcy and thus subverting a basic policy goal of the Code to foster equitable distribution among creditors is the policy rationale for the avoidance of preferences. The Commission's preference Recommendations focus on the treatment of small trade creditors under section 547 and clarifying the frequently litigated ordinary course of business exception.

Second, the treatment of tax claims requires a delicate balance of bankruptcy policy against the considerable power of a governmental unit to enforce its claim outside bankruptcy. Equality under the Bankruptcy Code requires similar treatment for similarly situated creditors. In this regard, tax policy sharply contrasts with bankruptcy policy. The Commission's Recommendations on the treatment of government tax claims address areas where these policies may be out of balance. In addition, while the Commission did not make a formal recommendation, a discussion of the police and regulatory exception to the automatic stay has been included in light of a recent proposed Congressional amendment to that section.

RECOMMENDATIONS

3.2.1 *Minimum Amount to Commence a Preference Action under 11 U.S.C. § 547*

11 U.S.C. § 547 should provide that $5,000 is the minimum aggregate transfer to a noninsider creditor that must be sought in a nonconsumer debt preference avoidance action.

3.2.2 *Venue of Preference Actions under 28 U.S.C. § 1409*

28 U.S.C. § 1409 should be amended to require that a preference recovery action against a noninsider seeking less than $10,000 must be brought in the bankruptcy court in the district where the creditor has its principal place of business. The Recommendation applies to nonconsumer debts only.

3.2.3 *Ordinary Course of Business Exception under 11 U.S.C. § 547(c)(2)(B)*

11 U.S.C. § 547(c)(2)(B) should be amended to provide a disjunctive test for whether a payment is made in the ordinary course of the debtor's business if it is made according to ordinary business terms. The ordinary course of business defense to a preference recovery action under section 547(c)(2) should provide as follows:

> **(2) to the extent that such transfer was in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee and such transfer was –**
>
> > **(A) made in the ordinary course of business or financial affairs of the debtor and the transferee; or**
> >
> > **(B) made according to ordinary business terms[.]**

3.2.4 *Ad Valorem Tax Priority under 11 U.S.C. § 724(b)*

11 U.S.C. § 724(b) should be amended to exempt from subordination properly perfected, nonavoidable liens on real or personal property of the estate arising in connection with an ad valorem tax. Section 724(b) should also require the trustee to marshal unencumbered assets of the bankruptcy estate and surcharge secured claims, if warranted by the

circumstances, under 11 U.S.C. § 506(c) prior to subordinating any tax liens under the statute.

3.2.5 *Burden of Proof for Tax Proceedings under 11 U.S.C. § 505*

The Bankruptcy Code should be amended to clarify that the burden of proof/persuasion rules and concomitant presumptions in tax controversies which would be applicable under nonbankruptcy law are equally applicable in bankruptcy court determinations of tax liabilities under 11 U.S.C. §§ 502 and 505.

3.2.6 *Exception of Tax Refund Setoffs under 11 U.S.C. § 362(b)*

11 U.S.C. § 362(b) of the Bankruptcy Code should be amended to allow a governmental unit to setoff an income tax refund that arose prior to the commencement of a Chapter 7 or Chapter 13 case against an 'undisputed' income tax liability of an individual debtor that arose prior to the commencement of the case.

DISCUSSION

Procedural preference reforms start with the premise that although the theory and substance of the preference power are sound, the practice of preference recovery is somewhat flawed. The concern is whether section 547 leads to abusive preference recovery suits by bankruptcy trustees who bring actions indiscriminately, without properly analyzing the creditor's available defenses and because the litigation costs associated with defending these actions outweigh the settlement amount the trustee is willing to accept.

The tension, therefore, is to develop efficient procedures to restrain abusive litigation techniques by the trustee without interfering with the policy goals of the preference power itself. These policy goals can be summed up as equality of treatment of creditors and deterring the "race to the courthouse" by creditors attempting to improve their position vis-a-vis the debtor on the eve of bankruptcy.[1949]

In addition, the ordinary course of business exception has been clarified so that either a sufficient course of prepetition dealing between the parties or conformance with industry standards will satisfy its requirements.

The second set of Recommendations address the procedure governing the treatment of tax claims. Treatment of tax claims in bankruptcy requires consideration of both bankruptcy and tax policy. Government entities are usually one of many creditors in a given bankruptcy case. The equilibrium sought by the Bankruptcy Code is to balance the interests of *all* creditors as well as the debtor. Where these interests are unbalanced, narrowly-defined solutions are necessary in order to prevent a different imbalance from arising under another part of the Code. The Commission's tax Recommendations attempt to address certain perceived imbalances without creating new inequities.

[1949] *See* Charles Jordan Tabb, *Rethinking Preferences*, 43 S.C. L. REV. 981, 986 (1992) ("Two rationales for preference law predominate: equality and deterrence — namely maximization of the value of the debtor's assets. These two policy goals conflict at times — as in the case of an ordinary course transfer shortly before bankruptcy. The distinction between good and bad preferences follows naturally from the identification of deterrence as the predominant purpose of preference law;" arguing for the repeal of the ordinary course of business exception).

3.2.1 *Minimum Amount to Commence a Preference Action under 11 U.S.C. § 547*

11 U.S.C. § 547 should provide that $5,000 is the minimum aggregate transfer to a noninsider creditor that must be sought in a nonconsumer debt preference avoidance action.

Preference reform proposals to the Commission have centered on the limited area involving smaller trade creditors from whom recovery of prepetition payments were sought by debtors in possession or trustees as avoidable preferences. In these instances there is, at times, a disincentive for such creditors to defend rather than settle the actions because the amount sought is small relative to the expense of defending against the preference action. This problem is exacerbated when the bankruptcy court is in a distant location, making it even more costly to defend. In addition, some creditors have noted that when Chapter 11 cases are converted to Chapter 7, a great deal of time has typically elapsed from the time of payment and the petition date to the date recovery is sought by the Chapter 7 trustee. In such instances, the demand may come as a surprise and long after the transaction was considered closed.

There is a dearth of scholarly analysis or data on preference abuses. For example, the perception of certain preference actions is that a trustee (or in rare instances, a debtor in possession) sends out a blanket complaint to virtually every creditor, particularly trade creditors, who received any payment within ninety days of the petition date. The trustee would have done little prior investigation other than to review the debtor's check register and would have made no effort to determine whether the creditors had any valid defenses. Given the relatively small amount of money at stake, it is rarely cost-effective for the creditor to contest the action, especially if the creditor is located in another jurisdiction at some distance from the bankruptcy court where the case is pending. As a result, those creditors are forced to settle the action regardless of its merits. This scenario can have perverse results if the preference recovery goes to pay the trustee and the trustee's professionals without any benefit flowing to unsecured creditors.

The American Bankruptcy Institute provided the Commission with the results of its survey of attorneys and credit managers canvassing a variety of preference experiences.[1950] The survey results provided support for a number of solutions to the problems faced by smaller trade creditors. Specifically, the ABI report proposed,

[1950] AMERICAN BANKRUPTCY INSTITUTE TASK FORCE ON PREFERENCES, PREFERENCE SURVEY REPORT (May 1997) (hereinafter "*Preference Report*").

among other things, raising the minimum amount sought in a preference action to limit coercive preference litigation tactics.[1951]

The Recommendation is an effort to protect smaller trade creditors who are most prone to abusive litigation tactics, and who are also least likely to have received a significant preference that would imperil the policies underlying the preference power. Raising the minimum aggregate transfer sought to $5,000 is consistent with current preference policies. Aggregate transfers of less than that amount are unlikely to create a substantial deviation from equality of treatment for creditors and it is doubtful that such a small transfer would pose a significant threat of premature scavenging of the estate's assets. The Recommendation does not affect the recovery of *any* transfer to an insider during the one year preference period.[1952] By increasing the minimum aggregate transfer that must be sought in a preference recovery, the Recommendation increases the likelihood that any amounts recovered will benefit creditors and not simply the trustee and his professionals. The Recommendation is limited to nonconsumer cases because most of the complaints the Commission received focused on smaller preference actions against trade creditors in Chapter 7 or Chapter 11 business bankruptcy cases.

Competing Considerations. A $5,000 minimum may be too high given the small size of most business cases. In small business cases, a $5,000 preference floor may eliminate any preference litigation, because there are rarely transfers of that size. The Recommendation addresses this concern by applying the $5,000 minimum to *aggregate* transfers during the preference period. A sufficient number of small transfers could be sought in a preference action provided the aggregate is above $5,000. All amounts transferred below an aggregate of $5,000 will not be recoverable under the Recommendation. Recovery of preferences in small cases may represent the only assets available for distribution to unsecured creditors. This aspect of the Recommendation runs counter to the overall structure and policies of the Bankruptcy Code favoring maximization of the total assets of the estate and equality of treatment for *all* unsecured creditors.

The Recommendation may also encourage aggressive prepetition debt collection of amounts just under $5,000. The preference power is intended to deter precisely that type of debt collection. By raising the minimum amount, creditors may be encouraged to collect just under the minimum prior to a debtor's bankruptcy filing. The Recommendation is designed to discourage aggressive debt collection by applying an *aggregate* limit of $5,000. Single transfers of amounts less than $5,000 would, however, not be avoidable as preferences under the Recommendation.

[1951] *Id.* at 25.

[1952] 11 U.S.C. § 547 (b)(4)(B) (1994).

3.2.2 *Venue of Preference Actions under 28 U.S.C. § 1409*

28 U.S.C. § 1409 should be amended to require that a preference recovery action against a noninsider seeking less than $10,000 must be brought in the bankruptcy court in the district where the creditor has its principal place of business. The Recommendation applies to nonconsumer debts only.

Section 1409(b) provides that a proceeding to recover a money judgment or property worth less than $1,000 must be commenced in the district court for the district in which the defendant resides.[1953] Section 1409(b) further provides that if the proceeding to recover a money judgment or property is on a consumer debt of less than $5,000, the action must be commenced in the district court where the defendant resides.[1954] The purpose of this provision is "to prevent unfairness to distant debtors of the estate, when the cost of defending would be greater than the cost of paying the debt owed."[1955]

The increased cost of defending a small preference action in a distant forum has encouraged reform of the preference venue rules. Consistent with the efforts to protect smaller trade creditors from certain preference litigation tactics, actions against noninsiders seeking recovery of an amount below $10,000 should be commenced in the district where the creditor has its principal place of business. The purpose of this venue provision is to protect parties from "noneconomic" actions brought by trustees seeking to take advantage of the likelihood that it will cost the creditors more to litigate the action than the action itself seeks to recover.

The Recommendation raises the venue floor for nonconsumer debts only to $10,000. The Recommendation, however, leaves the current floor for consumer debts at $5,000.[1956] By leaving the consumer level unchanged, trustees for consumer cases will not have to litigate in the creditor's forum unless the transfer is for less than $5,000. This discrepancy between actions on consumer debts and actions on nonconsumer debts is a change from the result under current law, but it is beneficial for a number of reasons. The Recommendation raises the litigation cost of bringing

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[1953] 28 U.S.C. § 1409(b) (1994).

[1954] *Id.*

[1955] 1 COLLIER ON BANKRUPTCY ¶ 3.02, 3-139 (Lawrence P. King, et al. eds., 15th ed. 1996) (*citing* H.R. REP. NO. 95-595, at 446 (1977)).

[1956] The Bankruptcy Code defines consumer debt as a "debt incurred by an individual primarily for a personal, family, or household purpose." 11 U.S.C. § 101(8) (1994).

small preference claims by requiring the action to be brought in the defendant's forum. This increased burden will fall on those debtors or trustees seeking to recover nonconsumer debts (mostly business debtors) and not on those seeking to recover on consumer debts (mostly consumer debtors). Transfers on consumer debts are generally smaller and any increase in the amount under the venue provisions may make any preference or property recovery in these cases unlikely. The Recommendation is designed to target only those business cases where there are perceived abuses of the preference power.

Raising the limit will increase the costs to the estate of bringing these actions.[1957] Hopefully, these increased costs will encourage debtors in possession and trustees to examine the merits more closely before commencing an avoidance action. Section 1409(b) generally was designed to deter "noneconomic" actions that cost more to defend than the action itself seeks. Creditor protection against blanket preference actions is furthered by raising the limit for invoking this provision. Increased costs may provide enough incentive for trustees and debtors in possession to look at the merits of each possible preference before commencing the action.

Competing Considerations. When a preference action is litigated, a trustee will often hire counsel to litigate it. Currently, only one venue applies to the vast majority of preference actions, enabling a trustee to hire one counsel to file one complaint against multiple preference recipients. The current system thus greatly reduces costs to the estate created by having to litigate multiple actions in multiple jurisdictions. It is also beneficial to the estate for the judge who is most familiar with the debtor and the case to hear the preference actions. Venue of preference actions balances the harm of increased costs to the estate with the harm suffered by creditors who must litigate in the debtor's forum. The positive effect of the Recommendation, however, is that if a trustee or debtor in possession has to litigate in the creditor's forum for all amounts between $5,000 and $10,000, the increased costs to the estate of bringing the action may encourage consideration of possible affirmative defenses, thus reducing abusive preference actions. The increased cost of preference litigation, however, will be borne by the unsecured creditors.

3.2.3 *Ordinary Course of Business Exception under 11 U.S.C. § 547(c)(2)(B)*

11 U.S.C. § 547(c)(2)(B) should be amended to provide a disjunctive test for whether a payment is made in the ordinary course of the debtor's business if it is made according to ordinary business terms. The ordinary course of business defense to a preference recovery action under section 547(c)(2) should provide as follows:

[1957] The Commission Recommendation on National Admission in Section 3.3.4 may reduce some of the cost of litigating preference claims in distant venues.

> **(2) to the extent that such transfer was in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee and such transfer was –**
>
> **(A) made in the ordinary course of business or financial affairs of the debtor and the transferee; or**
>
> **(B) made according to ordinary business terms[.]**

The ordinary course of business exception currently requires the recipient of a transfer to show that (1) the underlying debt was "incurred in the ordinary course of business or financial affairs" of both parties; (2) the transfer was made "in the ordinary course of business or financial affairs" of both parties; and (3) the transfer was "made according to ordinary business terms."[1958] The test under section 547(c)(2) is clearly in the conjunctive, requiring all three elements in order to establish that a payment falls into this exception to the preference power.[1959]

The purpose of the ordinary course of business exception to preference recoveries is "to protect recurring, customary credit transactions that are incurred and paid in the ordinary course of the debtor and the debtor's transferee."[1960] Some confusion exists, however, whether a payment is made in the ordinary course of business if it deviates from industry standards but is otherwise ordinary between the parties.[1961] In fact, the trend has gone from requiring proof of ordinary course between the parties to requiring ordinary course between the parties *and* within the

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[1958] 11 U.S.C. § 547(c)(2) (1994).

[1959] 4 COLLIER ON BANKRUPTCY ¶ 547.10 at 547-52 (Lawrence P. King et al. eds., 15th ed. 1996).

[1960] *Id.; see also* Tabb, *supra*, note 1949, at 989 ("upholding preferences made after the onset of insolvency. . . . is inconsistent with the fundamental tenet of equality of distribution that undergirds a bankruptcy or other collective proceeding that deals with an insolvent debtor.").

[1961] *Compare* Lovett Jr. v. St. Johnsbury Trucking, 931 F.2d 494, 498 (8th Cir. 1991) ("Late payments may be held to be made in the ordinary course of business, when such payment practices were well-established between the parties.") *with* Lawson v. Ford Motor Co. (*In re* Roblin Indus., Inc.), 78 F.3d 30, 39-40 (2d Cir. 1996) (citations omitted) ("[T]he thrust of § 547(c)(2)(C) . . . is clear . . . . [O]nly when a payment is ordinary from the perspective of the industry will the ordinary course of business defense be available for an otherwise voidable preference.").

The ABI Preference Report also proposed clarifying the ordinary course of business defense, recognizing the difficulty in deciding which transactions are "ordinary course" transactions. *Preference Report*, *supra*, note 1950, at 27.

industry, which is the express language in the Code.[1962] Some courts blur the distinction between course of conduct between the parties and industry standards, finding that only extremely aberrant transfers fall outside the exception.[1963]

The Recommendation adopts the view that the conduct between the parties should prevail to the extent that there was sufficient prepetition conduct to establish a course of dealing.[1964] A disjunctive test telescopes the ordinary course inquiry on the course of conduct between the parties. In the event there is not sufficient prepetition conduct to establish a course of dealing, then industry standards should supply the ordinary course benchmark.[1965] Quite often industry standards are extremely difficult to ascertain outside bankruptcy and difficult to prove in the context of preference litigation. Thus, it is more accurate to rely on the relationship between the parties.

Competing Considerations. It may be argued that debtors and creditors should not be encouraged to diverge from standard industry payment terms and manipulate their course of conduct prepetition. The current conjunctive requirements reinforce this policy goal. The Recommendation does not dissuade debtors and creditors from complying with industry standards, but rather focuses on the course of dealing to determine whether a transfer was made in the ordinary course of business.

[1962] *See In re* Excello Press, Inc., 967 F.2d 1109, 1114 (7th Cir. 1992) (court noted that prior to 1987, the test under section 547(c)(2)(B) & (C) required the same showing of course of dealing between the parties and that after 1987, the majority view is that satisfaction of both prongs is required).

[1963] *See, e.g., In re* Tolona Pizza Prod. Corp., 3 F.3d 1029, 1033 (7th Cir. 1993) ("'[O]rdinary business terms' refers to the range of terms that encompasses the practices in which firms similar in some general way to the creditor in question engage, and that only dealing so idiosyncratic as to fall outside that broad range should be deemed extraordinary and therefore fall outside the scope of [section 547(c)(2)(C)]").

[1964] This view has already been adopted by some courts. *See, e.g.*, Fiberlite Corp. v. Molded Acoustical Products (*In re* Molded Acoustical Products, Inc.), 18 F.3d 217, 220 (3d Cir. 1994) ("[S]ection 547(c)(2)(C) countenances a greater departure from that range of terms the longer the pre-insolvency relationship between the debtor and creditor was solidified").

[1965] A recent article proposed this amendment to address the problem of determining "industry standards." *See* Timothy M. Lupinacci, *Analyzing Industry Standards in Defending Preference Actions: Equitable Purpose in Search of Statutory Clarity*, 5 J. BANKR. L. & PRAC. 129, 168 (Jan./Feb. 1996) (concluding that the statute should be amended consistent with the Recommendation and that "[t]he legislative history should limit industry standard analysis to the situation in which the parties have no course of dealings prior to the payments made during the preference period.").

The Recommendation, however, will protect large transactions between sophisticated parties, which may limit the equality of distribution in these cases. If the parties have sufficient prepetition conduct to establish a course of dealing, the Recommendation eliminates any argument that the course of dealing did not comply with industry standards, and therefore, that the transfer was not in the ordinary course of business, particularly where industry standards are difficult to ascertain. Preference litigation in this area should be simplified as a result of the Recommendation.

3.2.4 *Ad Valorem Tax Priority under 11 U.S.C. § 724(b)*

11 U.S.C. § 724(b) should be amended to exempt from subordination properly perfected, nonavoidable liens on real or personal property of the estate arising in connection with an ad valorem tax. Section 724(b) should also require the trustee to marshal unencumbered assets of the bankruptcy estate and surcharge secured claims, if warranted by the circumstances, under section 506(c) prior to subordinating any tax liens under the statute.

Section 724(b) lies at the intersection of bankruptcy policy and tax policy. The statute governs the order of distribution of both real and personal property subject to valid, nonavoidable federal, state, and local tax liens[1966] in a Chapter 7 case. Liens or encumbrances that arise prior to the commencement of the case and are not otherwise invalidated[1967] are recognized as a charge upon assets.[1968] The general rule in a Chapter 7 liquidation case is that, upon any sale of property, the claims of secured creditors must be satisfied in full before any payment is made to claimants with a

[1966] A lien is a property interest protected by the Fifth Amendment of the Constitution. *See generally*, Wright v. Union Cent. Life Ins. Co., 311 U.S. 273, 279 (1940); Louisville Joint Stock Land Bank v. Radford, 295 U.S. 555, 584-85 (1935).

[1967] *See, e.g.*, 11 U.S.C. §§ 544, 545 (1994).

[1968] *See id.* § 101(37). Included among the liens that remain as a recognized charge upon assets are "statutory liens" such as tax liens. *See id.* § 101(53).

statutory priority[1969] or general unsecured creditors.[1970] Section 724(b) deviates from the general rule that unsecured priority claims do not trump perfected secured claims. The statute governs the order of distribution of *both* real and personal property subject to valid, nonavoidable federal, state, and local tax liens. Under section 724(b), a trustee is required to subordinate valid tax liens below the costs of administration and a number of other priority claims.[1971] The provision enables unsecured priority

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[1969] It is the rare Chapter 7 case in which a debtor has sufficient assets to pay all creditor claims in full. The Bankruptcy Code, out of this necessity, creates a "pecking order" or system of "priorities" which is designed to assure payment to certain classes of claims, to the extent possible, by requiring that they be paid first and in full before unsecured, nonpriority claims are entitled to any distribution. Section 507 specifies the nature of the claims entitled to priority treatment and the relative order in which they are to be paid. *See* 11 U.S.C. § 507(a)(1)-(9) (1994)(according priority status to such claims including all section 503(b) administrative expense claims, wage and pension claims, gap-period claims, claims of grain producers and fisherman, consumer deposits, and certain familial obligations). As a general rule, priority claims are subordinate to claims that are secured by a perfected lien against the debtor's property.

[1970] 11 U.S.C. §§ 363(f)(3), 725 (1994). Property of the estate can be sold free and clear of liens generally only if the sale price is greater than the aggregate value of all liens on the property. *Id.* § 363(f)(3). Thus, administrative expenses and other priority claims generally may not be charged against valid liens which must be satisfied out of the assets to which they attach. *See In re* Goffena, 175 B.R. 386, 389 (Bankr. D. Mont. 1994). *Cf.* 11 U.S.C. § 506(c) (1994) (setting forth an equitable exception to this rule).

[1971] 11 U.S.C. § 724(b) (1994). Section 724(b) provides:

> (b) Property in which the estate has an interest and that is subject to a lien that is not avoidable under this title 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), 507(a)(2), 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.

Id. (emphasis added). *See* C. RICHARD MCQUEEN & JACK F. WILLIAMS, TAX ASPECTS OF BANKRUPTCY LAW & PRACTICE, § 9:39 (3d ed. 1997) (providing several examples of the application of section 724(b)).

claimants occupying the first through seventh rungs on the priority ladder "to step into the shoes of the tax collector"[1972] and to receive distributions from property of the estate even though the tax claim is properly allowed and secured.[1973] The operation of section 724(b) also primes section 363(f)(3), which requires that property be sold for more than the aggregate liens on the property.[1974]

The subordination and amount distributable to priority claimants is, however, expressly limited to the extent of the tax lien,[1975] with partial payment of the tax lien if the priority claims are less than the amount of the lien, and no payment is permitted if the priority claims are greater than or equal to the amount of the tax lien.[1976] To the extent that the tax lien is subordinated, it is treated as a special category of unsecured claim that is payable prior to any distribution to the general creditors.[1977] In other words, certain priority claims are funded out of the secured tax claim in Chapter 7 cases to the extent of the tax lien.[1978] A number of courts interpreting section 724(b)

[1972] H.R. REP. NO. 95-595, at 382 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6338.

[1973] 124 CONG. REC. H11,014 (daily ed. Sept. 28, 1978) (remarks of Rep. Edwards); 124 CONG. REC. S17,431 (daily ed. Oct. 6, 1978) (remarks of Sen. DeConcini). Section 724(b) serves as a vehicle by which the lien interest of a taxing authority can be invaded in order to *create* equity for the bankruptcy estate. Indeed, section 724(b) effectively enables a trustee to administer property that is otherwise without value to the bankruptcy estate due to the existence of liens that in aggregate equal or exceed its fair market value (and, therefore, generally abandoned pursuant to section 554) in order to generate a pool of funds from which priority claims can be paid. *See* Morgan v. K.C. Machine & Tool Co. (*In re* K.C. Machine & Tool Co.), 816 F.2d 238, 246-47 (6th Cir. 1987) (holding that otherwise burdensome property should not be abandoned since the administration of the property would secure a fund in an amount equal to the tax liens from which to satisfy the fees of lawyers incurred in the previous Chapter 11 case); Marc Stuart Goldberg, P.C. v. City of New York (*In re* Navis Realty, Inc.), 193 B.R. 998, 1003 (Bankr. E.D.N.Y. 1996) (opining that section 724(b)(2) applies even if there is no equity in the property to be distributed).

[1974] *See In re* Oglesby, 196 B.R. 938, 942 (E.D. Va. 1996); *In re* Grand Slam USA, Inc., 178 B.R. 460, 463-64 (E.D. Mich. 1995); King v. Board of Supervisors (*In re* A.G. Van Metre, Jr., Inc.), 155 B.R. 118 (Bankr. E.D. Va. 1993), *aff'd*, 16 F.3d 414 (4th Cir. 1994) (Table).

[1975] 11 U.S.C. § 724(b)(2) (1994).

[1976] Hargrave v. Township (*In re* Tabone, Inc.), 175 B.R. 855, 859 (Bankr. D.N.J. 1994); *In re* Healthco Int'l, Inc., 174 B.R. 174, 177 (Bankr. D. Mass. 1994) (noting that subordination under section 724(b) can be "full or partial subordination").

[1977] 11 U.S.C. § 724(b)(5) (1994).

[1978] MCQUEEN & WILLIAMS, *supra* note 1971, § 9:39, at 9-63.

have held that a trustee is under no obligation to marshal unencumbered assets of the estate as a prerequisite to subordinating prior and otherwise valid tax liens.[1979]

Bankruptcy Code section 724(b) is derived from section 67c(3) of the former Bankruptcy Act. That section was enacted in response to the development of "spurious liens" under state law that were calculated "to distort the federally ordered scheme of distribution by depressing the position of priority claimants."[1980] The development and proliferation of taxes at all levels of government compounded the problem: "With little formality and frequently without any of the normal attributes of a lien interest, these [tax] claims were raised to the dignity of statutory liens. If all statutory liens, regardless of what they were in substance, were treated as liens in bankruptcy the order of federally created priorities would be completely disrupted."[1981] Congress recognized that such tax liens, especially in small cases, represented an acute example of where the assets of the bankruptcy estate may be entirely consumed to the exclusion of certain priority claims.[1982] Thus, section 67c(3) was enacted to provide that statutory liens on "personal property" would be subordinated to insure that two categories of claims would be satisfied: the costs of administration incurred in a liquidation case and certain wage claimants.[1983] Indeed, the legislative history reveals that:

> It would be grossly unfair for the bankruptcy court and the attorneys who have labored to wind up the bankrupt's affairs and to accumulate an estate for distribution to receive nothing for this labor. It is also socially desirable that the claims of the wage earner who is normally entirely dependent upon his wages for the necessity of life should be paid to the extent of the restriction in [the priority statute] before the estate is subject to the heavy burden of all tax liens.[1984]

[1979] *See, e.g.*, Wurst v. City of New York (*In re* Packard Properties, Ltd.), 112 B.R. 154, 158-59 (Bankr. N.D. Tex. 1990).

[1980] S. REP. NO. 89-1159 (1966), *reprinted in* 1966 U.S.C.C.A.N. 2456, 2457.

[1981] *Id.*

[1982] *Id. See* 4 COLLIER ON BANKRUPTCY ¶ 724.03, at 724-6-7 (Lawrence P. King et al. eds., 15th ed. 1996).

[1983] S. REP. NO. 89-1159 (1966), *reprinted in* 1966 U.S.C.C.A.N. 2456, 2457, 2460. *See* 4 COLLIER ON BANKRUPTCY ¶ 67.27[1] 367 (James Wm. Moore ed., 14th ed. 1978). Section 67c(3) amended the Chandler Act by eliminating the requirement of *actual possession* as the standard for priming statutory liens on personal property.

[1984] S. REP. NO. 89-1159 (1966), *reprinted in* 1966 U.S.C.C.A.N. 2456, 2462.

The "sole" concern of Congress in enacting section 67c(3) was to guarantee the payment of the costs of administration in a Chapter 7 case and small wage claimants.[1985] Because section 67c(3) subordinated tax liens only on "personal property," the provision did not represent a significant threat to tax revenues.[1986]

Section 724(b), as enacted, expanded prior law by subordinating tax liens on both personal and real property.[1987] In addition, valid tax liens are subordinated to a number of priority claimants beyond those subordinated under Bankruptcy Act section 67c(3).[1988] The legislative history to the Code refers to both types of tax liens that are subordinated beyond those liens subordinated under the Bankruptcy Act.[1989] Additionally, some courts expand section 724(b) further to permit administrative claimants in a superseded Chapter 11 case to subordinate tax liens after conversion of the case from Chapter 11 to Chapter 7.[1990]

[1985] *Id.; see also* California State Dept. of Employment v. United States, 210 F.2d 242, 244 (9th Cir. 1954).

[1986] The legislative history to the Code, as buttressed by the Report of the Commission on the Bankruptcy Laws of the United States, reveals that the drafters intended to limit the reach of the statute and exempt ad valorem taxes on real property from subordination. *See* H.R. REP. NO. 95-595 at 382 (1977) (referring generally to "liens" on property), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6338; S. REP. NO. 95-989, at 96 (1978) (referring to liens on personal property only), *reprinted in* 1978 5787, 5882; H.R. DOC. NO. 137, 93d Cong., 1st Sess. 212 (1973), *reprinted in* A & P Legislative History, at 476.

[1987] *See* H.R. REP. NO. 95-595, at 382 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6338 (indicating that section 724(b) was derived from section 67c(3), "without substantial modification in result").

[1988] The substantial expansion of the categories of priority claims since the inception of our bankruptcy laws has, over the years, led to a continued erosion of the secured position of taxing authorities. *See, e.g.*, 11 U.S.C. §§ 507(a)(7) (according priority status to certain familial obligations), 503(b)(3)(F) (1994) (according priority status to the expenses of members of a creditors' committee incurred in connection with committee service) (added to the Code by the Bankruptcy Reform Act of 1994, Pub. L. No. 103, 108 Stat. 4106).

[1989] The legislative history on section 724(b) refers to both the subordination of personal property tax liens as well as the subordination of all tax liens. *Compare* S. REP. NO. 95-989,at 96 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5882 (section 724(b) " retains the rule of present bankruptcy law . . . that a tax lien on personal property, if not avoidable by the trustee, is subordinated in payment to unsecured claims having a higher priority than unsecured tax claims.") *with* H.R. REP. NO. 95-595, at 382 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6338 ("section 724(b) subordinates tax liens to administrative expense and wage claims"); H.R. DOC. NO. 95-137, at 212 (1977).

[1990] *See, e.g.*, Morgan v. K.C. Machine & Tool Co. (*In re* K.C. Machine & Tool Co.), 816 F.2d 238 (6th Cir. 1987).

Section 724(b) does not disturb the relative positions of senior and junior consensual lienholders as well as unsecured creditors.[1991] If higher priority unsecured claims equal or exceed the amount of the tax lien, the once-secured tax claim may become completely unsecured and the lien is effectively extinguished. As a result, both higher priority unsecured claims and junior lienholders can realize upon the collateral to the exclusion of senior tax claimants.[1992] The ability of state and local governments to provide essential public services rests on their ability to generate revenue through taxation. Section 724(b) may undermine that support, especially for local governments whose source of revenue is derived almost exclusively from the taxation of real property.

Prior to 1994, a number of circuit courts held that the automatic stay prevented statutory liens from attaching to property for taxes accruing after the bankruptcy filing. Congress responded in 1994 by amending section 362 in order to allow local governments to utilize their lien attachment authority and secure the payment of property taxes.[1993] This amendment created a glitch in the result under section 724(b). As a result of the recent amendment to section 362(b)(9), section 724(b) has the anomalous result of allowing unsecured claims for taxes and penalties incurred by the estate and entitled to priority under sections 507(a)(1) and 503(b)(1)(B)-(C) to trump prior and perfected tax liens.[1994]

An amendment similar to the Recommendation was recently introduced in the Senate.[1995] The difference between the amendment proposed in the Senate and the Recommendation is that the Senate amendment permits the payment of "claims for wages, salaries and commissions entitled to priority under section 507(a)(3) or claims for contributions to an employee benefit plan entitled to priority under 507(a)(4)" from property secured by a tax lien.[1996] Another difference between the Recommendation and the pending legislation is that the Recommendation requires a trustee to marshal the assets prior to subordinating *any* tax lien. The Senate bill

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[1991] H.R. REP. NO. 95-595, at 382 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6338.

[1992] Challenges to the constitutionality of stripping taxing authorities of their liens under section 724(b) have failed. *See, e.g.*, Wurst v. City of New York (*In re* Packard Properties, Ltd.), 112 B.R. 154, 157 (Bankr. N.D. Tex. 1990).

[1993] *See* 11 U.S.C. §§ 362(b)(9), (18) (1994).

[1994] *See, e.g.*, Marc Stuart Goldberg, P.C. v. City of New York (*In re* Navis Realty, Inc.), 193 B.R. 998, 1005 (Bankr. E.D.N.Y. 1996).

[1995] The Investment in Education Act of 1997, S. 1149, 143 CONG. REC. S8823, *8827, 1997 WL 541068 (September 4, 1997).

[1996] *Id.* at *S8828.

requires a trustee to marshal only before subordinating a tax lien "which has arisen by virtue of state law."[1997] Under the proposed bill, federal tax liens may thus be subordinated prior to the trustee marshaling all unencumbered assets.

The second portion of the Recommendation requires the trustee to "marshal" all of the unencumbered assets of the estate and surcharge all secured parties before subordinating a tax lien under section 724(b). In furtherance of the Bankruptcy Code's goal of equality of distribution, the trustee (or the debtor in possession) is given a number of tools in order to unwind prepetition transfers and bring those assets back into the estate for distribution under the Bankruptcy Code.[1998] While the authorities are divided on the issue, some courts have found that there is absolutely no requirement that the Chapter 7 trustee exhaust all unencumbered funds of the bankruptcy estate in the payment of administrative expenses and other specified priority claims before paying priority claims by resort to subordination of tax liens under section 724(b). Indeed, some courts have held that the trustee is under no obligation to marshal assets as a prerequisite to subordinating an otherwise valid tax lien since Congress intended to impose the burden of administration, to some extent, on taxing authorities.[1999]

As previously outlined, the proliferation of administrative and other priority claims over the years by numerous amendments to the Bankruptcy Code has expanded the operation of section 724(b) far beyond its original design.[2000]

[1997] *Id.*

[1998] The trustee (or the debtor in possession under section 1107(a)) has a number of tools at her disposal, including the powers of a judicial lien creditor and a bona fide purchaser of real property under section 544(a). In addition, the trustee has standing to raise state law causes of action under section 544(b).

[1999] *See, e.g.*, Wurst v. City of New York (*In re* Packard Properties, Ltd.), 112 B.R. 154, 158-59 (Bankr. N.D. Tex. 1990). *But see, e.g., In re* Buzzworm, Inc., 178 B.R. 503, 511 (Bankr. D. Colo. 1994); *In re* Dowco Petroleum, Inc., 137 B.R. 207, 210 (Bankr. E.D. Tex. 1992); *In re* Granite Lumber Co., 63 B.R. 466, 473 (Bankr. D. Mont. 1986) (opining that priority claims may be satisfied with funds intended to satisfy lienholders under section 724(b) only when no funds are available from estate property under section 726).

[2000] *See* 11 U.S.C. §§ 348(d), 726(a), (b) (1994). *See, e.g.*, Morgan v. K.C. Machine & Tool Co. *(In re* K.C. Machine & Tool Co.), 816 F.2d 238 (6th Cir. 1987). The dissent in *Morgan* aptly noted that section 724(b) may operate to extinguish a secured tax lien, a prior perfected property right, and redistribute public funds to

> a group of Chapter 11 administrative creditors, mainly Detroit law firms, who had no prior security or other perfected property interest in any of the property of the bankrupt. The lawyers, whose unsecured accounts arose in the administration of the [case] after the [taxing authority] had perfected its liens, are given public tax

Competing Considerations. As the legislative history to the enactment of the statute clearly reveals, the provision subordinating tax liens was originally designed, in large part, to ensure that those who work for the bankruptcy estate in a liquidation case get paid.[2001] Amendment of section 724(b) may decrease the pool of assets available to satisfy administrative expenses and other priority claims. In high risk cases, it may be difficult to find competent professionals to administer the case or the debtor's employees may be reluctant to remain and assist a liquidation for fear of not being compensated. Similar to all other creditors, tax creditors benefit from the quick and efficient administration of bankruptcy estates and should bear the cost of administration along with the other creditors.

For these reasons, it is appropriate for Congress to determine the relative priority of tax claims as part of a comprehensive bankruptcy statute, notwithstanding that Congress or state legislatures have accorded secured status to certain tax claims to enhance the tax authority's collection capabilities outside of bankruptcy. The fact that Congress has on several occasions lowered the general tax priority under section 507(a) with the result that section 724(b) subordinates otherwise secured tax claims to new claims having a higher priority is not in itself a reason for amending subordination under section 724(b). It is a reason for reexamining the general tax priority under section 507(a).

Two additional considerations must be weighed when making a fundamental policy decision with respect to section 724(b). First, tax claims already receive significant protection by virtue of their elevated position on the priority ladder. Second, most tax obligations are nondischargeable in individual cases.[2002] Other secured creditors are protected by section 523(a) and do not lose the benefit of valid liens simply because of the advent of bankruptcy, nor are tax liens only subordinated when they relate to nondischargeable taxes. The Recommendation is designed to restore the balance for *ad valorem* tax claimants in light of the treatment for other secured creditors under the Bankruptcy Code.

While these reasons may justify priming a tax lien claim generally, the Recommendation carves out *ad valorem* tax claims from this treatment. The

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funds. Such a result may raise serious constitutional questions . . . .

Id. at 248 (Merritt, J., dissenting).

[2001] *See generally* H.R. REP. NO. 95-595, at 186-87 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6147 ("Those who must wind up the affairs of the debtor's estate must be assured of payment, or else they will not participate in the liquidation or distribution of the estate.").

[2002] *See* 11 U.S.C. §§ 507(a)(8), 523(a)(1) (1994). It should be noted, however, that more tax claims are dischargeable in Chapter 13. *See* 11 U.S.C. § 1328 (1994).

requirement that trustees marshal assets and surcharge creditors may increase the administrative costs, though no data on increased costs to the estate is available. In the event administrative costs increase, any attendant benefit recovered by the estate will be used to pay the trustee's and the trustee's professionals' fees incurred to marshal those assets and surcharge the secured creditors.

3.2.5 *Burden of Proof for Tax Proceedings under 11 U.S.C. § 505*

The Bankruptcy Code should be amended to clarify that the burden of proof/persuasion rules and concomitant presumptions in tax controversies which would be applicable under nonbankruptcy law are equally applicable in bankruptcy court proceedings to determine tax liabilities under 11 U.S.C. §§ 502 and 505.

Bankruptcy courts have jurisdiction under section 505 to hear and determine the amount or legality of *"any"* unpaid tax claim, regardless of whether or not the tax and its concomitant fines and penalties have been previously assessed or contested.[2003] The jurisdictional grant contained in section 505(a)(1) is sufficiently broad to include the determination or legality of any type of tax liability "whether or not paid" or previously adjudicated by a judicial or administrative tribunal of competent jurisdiction.[2004] Courts have construed the statute and its concomitant policy objective to permit the prosecution in a bankruptcy forum of a *de novo* appeal from an unpaid tax assessment.[2005]

[2003] Section 505(a)(1) provides:

> Except as provided in paragraph (2) of this subsection, the court may determine the amount or legality of any tax, any fine, or penalty relating to a tax, or any addition to tax, whether or not previously assessed, whether or not paid, and whether or not contested before and adjudicated by a judicial or administrative tribunal of competent jurisdiction.

11 U.S.C. § 505(a)(1) (1994). *See* MCQUEEN & WILLIAMS, *supra* note 1971, § 3:14.

[2004] *See infra* note 2006. *See generally* Perry v. District of Columbia, 314 A.2d 766, 766 (D.C.), *cert. denied*, 419 U.S. 836 (1974) (noting that the jurisdictional prerequisite to a judicial review of a tax assessment under the law of the District of Columbia hinges upon the *actual payment* of the disputed tax assessment together with interest and penalties).

[2005] *See, e.g.*, Laptops Etc. Corp. v. District of Columbia (In re Laptops Etc. Corp.), 164 B.R. 506 (Bankr. D. Md. 1993) (ruling that the taxing authority's sales-tax assessment, as affirmed by the Department of Revenue postpetition, was an unconstitutional violation of the Commerce Clause and without force and effect; claims disallowed). By virtue of section 505(a), a bankruptcy court may even determine the validity of a debtor's tax liability, if any, irrespective of whether it had previously granted relief from the automatic stay to permit the continuation of a tax court proceeding on the same issue. *See, e.g.*, United States v. Wilson, 974 F.2d 514, 517 (4th Cir. 1992), *cert.*

Section 505(a)(2) contains a limitation on the jurisdiction of the bankruptcy court to determine the amount or legality of a tax claim and resolve tax disputes. Under that section, a bankruptcy court is not permitted to redetermine the merits of a tax claim or question of tax liability that has been contested before the commencement of the bankruptcy case in a state, federal or quasi-judicial tribunal.[2006] Section 505(b), by contrast, provides a trustee or debtor in possession with the ability to obtain a determination of any postpetition tax liability which arises during the pendency of the case.[2007]

The Bankruptcy Code is structured to achieve a relatively expeditious resolution with respect to disputes over the amount, validity and character of claims to the bankruptcy estate. Without this broad mandate to resolve claims against the estate, it would be difficult for the bankruptcy court to accomplish this goal. In order to resolve all claims against the estate, the Bankruptcy Code and the Bankruptcy Rules provide a detailed claims procedure. A proof of claim executed and filed in accordance with section 501 of the Bankruptcy Code and applicable Bankruptcy Rules constitutes *prima facie* evidence of the amount and validity of the claim.[2008] Upon objection to the claim and admission of probative evidence sufficient to rebut the *prima facie* validity of the claim, the burden shifts to the claimant who bears the

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denied, 507 U.S. 945 (1993); *In re* Swann Gasoline Co., 46 B.R. 640, 642 (Bankr. E.D. Pa. 1985) (noting that even if relief from the automatic stay were afforded in order to permit a state court to make determinations of tax liability, such determinations would not have res judicata or collateral estoppel effect as to the bankruptcy court's own determination of liability under section 505(a)).

[2006] Section 505(a)(2) provides in pertinent part:

> (2) The court may not so determine--
>
> (A) the amount or legality of a tax, fine, penalty, or addition to tax if such amount or legality was contested before and adjudicated by a judicial or administrative tribunal of competent jurisdiction before the commencement of the case under this title . . . .

11 U.S.C. § 505(a)(2) (1994).

[2007] *See id.* § 505(b) ("A trustee may request a determination of any unpaid tax liability of the estate for any tax incurred during the administration of the case . . . .").

[2008] *See* FED. R. BANKR. P. 3001(f). *See* 11 U.S.C. § 502(a) (1994) (providing that a claim is "deemed allowed" unless a party in interest objects). *See also* Whitney v. Dresser, 200 U.S. 532, 535-36 (1906) (opining that it is the objection, not the claim, which is heard in a claims contest and that the claim in bankruptcy is regarded as having a certain standing); 4 COLLIER ON BANKRUPTCY ¶ 502.02[2][f], at 502-19 (Lawrence P. King et al. eds., 15th ed. 1996) ("Unless the trustee, as objector, introduces evidence as to the invalidity of the claim or the excessiveness of its amount, the claimant need offer no further proof on the merits of the claim.").

ultimate burden of persuasion with respect to the amount and validity of its claim.[2009] This claim assertion and objection process is the same for all creditors.

Significantly, within the claim allowance framework of the Bankruptcy Code, the courts already recognize an exception to the general rule that the claimant has the ultimate burden of proof. When the facts are peculiarly within the knowledge of one party, then the burden of proving an issue lies with the knowledgeable party.[2010] In other words, even within the context of present law, the court, using its equitable powers, may shift the burden of proof in the interests of justice.

In fora other than a bankruptcy court, however, the burden of persuasion to refute the validity of the government's tax claim generally falls upon the taxpayer, not the government.[2011] Consequently, bankruptcy courts must determine whether the

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[2009] The burden of proof in bankruptcy is a shifting one:

> [A] claim is *prima facie* valid if it alleges facts sufficient to support a legal liability to the claimant; if the objector then produces evidence to refute at least one of the allegations essential to the claim's legal sufficiency, the burden of going forward shifts back to the claimant to prove the validity of the claim by a preponderance of the evidence.

3 COLLIER ON BANKRUPTCY ¶ 502.01, at 502-18 n.19 (Lawrence P. King et al. eds., 15th ed. 1996) (citing *In re* Allegheny Int'l, Inc., 954 F.2d 167 (3d Cir. 1992)). One rationale for imposing the ultimate burden of persuasion upon the claimant in a dispute with the trustee or debtor-in-possession is that, from a purely procedural standpoint, the filing of a proof of claim is tantamount to the filing of a complaint in a civil action. *See* Nortex Trading Corp. v. Newfield, 311 F.2d 163 (2d Cir. 1962). As such, the claimant in a bankruptcy proceeding is essentially in the same posture as a plaintiff in a nonbankruptcy proceeding, who is generally assigned the burden of proving its claim against the defendant. *In re* Premo, 116 B.R. 515, 518 (Bankr. E.D. Mich. 1990). Also, placing the burden of proof on the claimant assures equality of treatment with respect to all holders of claims by requiring each person having a claim to file a proof of claim with the court and to bear the burden of substantiating it if it is contested.

[2010] Waterman Steamship Corp. v. Aguiar (*In re* Waterman Steamship Corp.), 200 B.R. 770, 775 (Bankr. S.D.N.Y. 1996).

[2011] "[T]he usual procedure for recovery of debts is reversed in the field of taxation. Payment precedes defense, and the burden of proof, normally on the claimant, is shifted to the taxpayer." Bull v. United States, 295 U.S. 247, 260 (1935). *Accord* United States v. Janis, 428 U.S. 433, 440 (1976), *reh'g denied*, 429 U.S. 874 (1977); Helvering v. Taylor, 293 U.S. 507, 515 (1935); Welch v. Helvering, 290 U.S. 111, 115 (1933). *See, e.g.*, T. CT. RULE PRAC. & PROC. 142(a); D.C. CODE ANN. § 47-2010 (1990) (providing for a presumption of taxability and allocating the burden to the taxpayer to prove that a receipt is not subject to sales taxation). In proceedings before the Tax Court, the Court of Federal Claims or a district court, it is incumbent upon the taxpayer, as the party seeking a redetermination of liability, to discharge the burden of proof by a preponderance of the evidence. Moreover, when an assessment has been formally made by the taxing authority, it carries with it a presumption of correctness which must be overcome by the taxpayer. *See* Psaty v. United

claim of a taxing authority should be treated like all other claims. In other words, whether the taxing authority (like every other creditor in bankruptcy) must prove that it has a valid claim, or whether the debtor, debtor in possession, or trustee is required to persuade the bankruptcy court that the taxing authority does not have a valid claim.[2012]

The courts are in substantial and direct conflict over whether the burden of proof in a tax matter is borne by the IRS or by the debtor. The Courts of Appeals for the Third, Fourth and Seventh Circuits have ruled that the Bankruptcy Code and Rules do not alter the burden of proof rules for tax claims under nonbankruptcy law.[2013] Accordingly, those courts have placed the burden on the debtor-taxpayer in a claims contest. The Courts of Appeals for the Fifth, Sixth, Ninth and Tenth Circuits have reached the opposite conclusion, finding that the government should be treated the same as every other creditor in the claims objection process.[2014] The confusion in this area can perhaps be best illustrated by the fact that the Court of Appeals for the Eighth Circuit has weighed in on both sides of the issue.[2015] Lower courts are equally

States, 442 F.2d 1154 (3d Cir. 1971); United States v. Molitor, 337 F.2d 917 (9th Cir. 1964).

[2012] Elmer Dean Martin III, *Burden of Persuasion: The Overlooked Defense to Tax Claims*, 21 CAL. BANKR. J. 117 (1993); *see* MCQUEEN & WILLIAMS, *supra* note 1971, § 7:25.

[2013] *See, e.g.*, United States v. Charlton, 2 F.3d 237, 239 (7th Cir.), *reh'g en banc denied*, 1993 U.S. App. LEXIS 32378 (1993); IRS v. Levy (*In re* Landbank Equity Corp.), 973 F.2d 265 (4th Cir. 1992); Resyn Corp. v. United States, 851 F.2d 660 (3d Cir. 1988). "[U]pon review of the code and its legislative history, we find nothing which suggests that this dispute between a taxpayer and the IRS should be decided in a manner any different from that in which the case would be determined outside the bankruptcy context." *Levy*, 973 F.2d at 270-71.

[2014] *See, e.g.*, Franchise Tax Bd. v. MacFarlane (*In re* MacFarlane), 83 F.3d 1041 (9th Cir. 1996), *cert. denied*, 117 S. Ct. 1243 (1997); Placid Oil Co. v. IRS *(In re* Placid Oil Co.), 988 F.2d 554 (5th Cir.), *reh'g denied*, 4 F.3d 992 (5th Cir. 1993); *In re* Fullmer, 962 F.2d 1463 (10th Cir. 1992); *In re* Fidelity Holding Co., 837 F.2d 696 (5th Cir. 1988); Industrial Comm'r v. Highway Constr. Co. (*In re* Highway Constr. Co., 105 F.2d 863 (6th Cir. 1939) (pre-Code case).

[2015] *Compare* Gran v. IRS *(In re* Gran), 964 F.2d 822 (8th Cir. 1992); Paschal v. Blieden, 127 F.2d 398 (8th Cir. 1942)(Act case) (imposing the burden on the government) *with In re* UNECO, Inc., 532 F.2d 1204 (8th Cir. 1976)(Act case) (imposing the burden on the debtor-taxpayer).

divided.[2016] In fact, two commentators, in analyzing the cases have identified not two, but four separate principles for allocating the burden of proof.[2017]

The allocation of the burden of proof in many tax controversies is often determinative, as indicated by the above litigation over allocation of that burden. Consequently, the burden may have a substantive effect on the tax claim rather than simply a claims resolution procedure under the Bankruptcy Code. Indeed, "[i]n resolving disputed claims against the bankruptcy estate, it is important to understand that the Bankruptcy Code, in most instances, while providing a forum and procedures for an expedient dispute resolution, does not endeavor to supplant the substantive law under which the claim against the estate arose."[2018] To the contrary, it is axiomatic under the Bankruptcy Code that the *validity* of a creditor's claim is determined by the rules of nonbankruptcy law.[2019]

[2016] *Compare In re* Wilhelm, 173 B.R. 398, 401-02 (Bankr. E.D. Wis. 1994); *In re* Premo, 116 B.R. 515, 524 (Bankr. E.D. Mich. 1990) (refusing to recognize an exception to the rule allocating the burden of ultimate persuasion upon the creditor for tax authorities in the context of a hearing on an objection to a claim); *In re* Federated Dep't Stores, Inc., 135 B.R. 950, 958 (Bankr. S.D. Ohio 1992), *aff'd*, 171 B.R. 603 (S.D. Ohio 1994) *with* Abel v. United States (*In re* Abel), 200 B.R. 816, 819 (E.D. Pa. 1996); *In re* Thinking Machs. Corp., 203 B.R. 1 (Bankr. D. Mass. 1996) (concluding that Bankruptcy Rule 3001(f) places the ultimate burden of proof and persuasion upon the government, improperly permits a tax litigant to shift the burden of proof by merely filing bankruptcy); *In re* Ford, 194 B.R. 583, 588-89 (S.D. Ohio 1995); Cobb v. United States (*In re* Cobb), 135 B.R. 640, 641 (Bankr. D. Neb. 1992) (concluding that Bankruptcy Rule 3001(f) does not allocate the burden of proof but simply establishes that a proof claim constitutes evidence: "The Rule, in effect creates a presumption which must be overcome by debtor. Once the presumption is overcome . . ., the proof of claim no longer constitutes evidence--the bubble is burst. The burden of proof is to then be allocated by applicable non-bankruptcy law.").

[2017] Henderson and Goldring, FAILING AND FAILED BUSINESSES, § 1013.4 (1997).

[2018] Internal Rev. Serv. v. Levy (*In re* Landbank Equity Corp.), 973 F.2d 265, 270 (4th Cir. 1992) (citing Report of the Commission on the Bankruptcy Laws of the United States, H.R. DOC. NO. 137, 93d Cong., 1st Sess. Pt. I 68-71, 76-78 (1973)). The United States Supreme Court has found that "presumptions (and their effects and burden of proof) are 'substantive,'" not procedural. *See* Dick v. New York Life Ins. Co., 359 U.S. 437, 446 (1959).

[2019] *See* Grogan v. Garner, 498 U.S. 279, 283-84 & n.9 (1991). The United States Supreme Court has opined that it is imperative to

> distinguish between the standard of proof that a creditor must satisfy in order to establish a valid claim against the bankrupt estate and the standard that a creditor who has established a valid claim must still satisfy in order to avoid dischargeability. The validity of a creditor's claim is determined by rules of state law [defined] expansively . . . to refer to all nonbankruptcy law that creates substantive claims. . . . [H]owever, the issue of nondischargeability has been a matter of federal law governed by the terms of the Bankruptcy Code.

The same burden of proof and persuasion is placed on every creditor asserting a claim in a bankruptcy case. Notwithstanding this implicit congressional directive, there is no statutory provision or expression in the legislative history evidencing an intent by Congress that the burden under tax law should be displaced in bankruptcy. Nor is there any indication in bankruptcy law that tax claims should receive different treatment. The result is relatively clear: When a taxpayer seeks relief under the bankruptcy laws, it is able to garner a different process for the determination of its tax liability.[2020] The uniform treatment of tax claims through an adherence to nonbankruptcy law burdens and presumptions serves to reduce uncertainty, discourages bankruptcy filings for tax liability forum-shopping reasons, and prevents a party from receiving a different process for determination of its tax claim not otherwise obtainable outside of bankruptcy.

The government's position as a tax creditor in a claims contest is different from other creditors in a normal debtor-creditor relationship. It is generally the debtor or the debtor in possession who has access to all of the relevant records, information and knowledge required to substantiate or contest the validity of a tax claim. As such, "[t]he common law rule placing the burden on the party with access to the facts seems particularly applicable in a self-assessment system which provides for the taxpayer to make the initial determination of liability" and bolsters the record-keeping requirement the Internal Revenue Code imposes upon taxpayers.[2021] To the extent one creditor is prevented from being able to prove its claim due to lack of information, other creditors benefit to the detriment of that creditor. The Recommendation is designed to protect tax creditors from that result.

Competing Considerations. Under the Bankruptcy Code and Rules, every creditor must file a proof of claim supporting its claim.[2022] There is appeal to the premise adopted by those courts that all creditors should be subject to the same proof requirements under the Bankruptcy Code. Fundamental bankruptcy policy compels equal procedural treatment of creditors.

Id. (footnote inserted & citations omitted).

[2020] Section 505(a)(2) precludes a bankruptcy court from determining the amount or legality of any tax claim if the merits of a tax claim or question of liability has been contested prior to the commencement of the bankruptcy case where the nonbankruptcy law burdens and presumptions are applicable. 11 U.S.C. § 505(a)(2) (1994).

[2021] 15 COLLIER ON BANKRUPTCY ¶ TX5.03[5], at TX5-24 (Lawrence P. King et al. eds., 15th ed. 1996).

[2022] *See, e.g.*, 11 U.S.C. § 501 (1994); FED. R. BANKR. P. 3001 (listing requirements for a proof of claim).

Shifting the burden of proof to the debtor does more than meets the eye. A number of cases have held that the taxing authority gets the benefit of the presumption of validity for its tax claim without filing supporting documentation.[2023] The debtor may not be in a position to know the basis for the taxing authority's position and therefore may not know the extent of the burden she must meet. Under present practice, notwithstanding that a taxing authority has a minimum 180-day period for filing a proof of claim,[2024] the taxing authority may file an estimated proof of claim disallowing all deductions because it has not completed its own review. The notion that placing the burden of proof on the debtor mirrors the situation outside of bankruptcy is erroneous, since outside of bankruptcy the tax process is likely to require the taxing authority to mail a notice of deficiency or to make an assessment setting forth the adjustments that the taxing authority proposes to make. Placing the burden of proof on the debtor in bankruptcy prior to the time that a notice of deficiency has been mailed or an assessment has been made puts the debtor under a greater burden than she would bear outside of bankruptcy.

The rationale for the Recommendation that the debtor has all of the relevant tax information and therefore the debtor should bear the burden of proof under section 505 is less powerful when the taxing authority is litigating against a bankruptcy trustee or the creditors. Under these circumstances, the trustee or the creditors have even less information than the government and usually enjoys an equally hostile relationship with the debtor. The shift of the burden to such parties under these circumstances is inequitable and any attendant losses will be borne by the other creditors.

The Recommendation recognizes the unique nature of tax claims and attempts to conform bankruptcy procedure to the rules outside of the bankruptcy process.[2025]

[2023] *In re* Los Angeles International Airport Hotel Assoc., 106 F.3d 1479 (9th Cir. 1997) (citing cases).

[2024] 11 U.S.C. § 502(b)(9) (1994).

[2025] *See, e.g.*, 11 U.S.C. §§ 507(a)(8), 523(a)(1) (1994).

> In a broad sense, the goals of rehabilitating debtors and giving equal treatment to private voluntary creditors must be balanced with the interests of governmental tax authorities who, if unpaid taxes exist, are also creditors in the proceeding.
>
> Since tax authorities are creditors of practically every taxpayer, another important element is that tax collection rules for bankruptcy cases have a direct impact on the integrity of Federal, State and local tax systems. These tax systems, generally based on voluntary assessment, work to the extent that the majority of taxpayers think they are fair. This presumption of fairness is an asset which should be protected and not jeopardized by permitting taxpayers to use bankruptcy

3.2.6 *Exception of Tax Refunds Setoffs under 11 U.S.C. § 362(b)*

11 U.S.C. § 362(b) of the Bankruptcy Code should be amended to allow a governmental unit to setoff an income tax refund that arose prior to the commencement of a Chapter 7 or Chapter 13 case against an 'undisputed' income tax liability of an individual debtor that arose prior to the commencement of the case.

Section 362(a) of the Bankruptcy Code provides for a broad, automatic stay upon the filing of a bankruptcy petition under any chapter of the Code.[2026] The stay enjoins further litigation, lien enforcement, and other conduct (formal or informal), judicial or otherwise, that attempt to collect prepetition claims.[2027] The automatic stay applies to "all entities," including governmental units.[2028] Bankruptcy courts are empowered to award sanctions for violations of the stay.[2029] Without the power to award sanctions for violations of the stay, bankruptcy courts would be powerless to enforce its provisions, which benefit creditors and the debtor alike by preserving the status quo as of the commencement of the case.

Automatic stay protection is not, however, unlimited. Section 362(b) sets forth a number of self-executing exceptions for certain types of actions that justify a

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> as a means of improperly avoiding their tax debts. To the extent that debtors in a bankruptcy are freed from paying their tax liabilities, the burden of making up the revenues thus lost must be shifted to other taxpayers.

S. REP. NO. 95- 989, at 13-14 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5799-5800.

[2026] 11 U.S.C. § 362(a) (1994).

[2027] The rationale for the imposition of the automatic stay has been expressed as follows:

> The stay provides the debtor with relief from the pressure and harassment of creditors seeking to collect their claims. It protects property that may be necessary for the debtor's fresh start and, in terms of a Chapter 11 debtor, provides breathing space to permit the debtor to focus on its rehabilitation or reorganization. In addition, the stay provides creditors with protection by preventing the dismemberment of a debtor's assets by individual creditors levying on the property. This promotes the bankruptcy goal of equality of distribution.

3 COLLIER ON BANKRUPTCY ¶ 362.03, at 362-13 (Lawrence P. King et al. eds., 15th ed. 1996) (citing H.R. REP. NO. 95-595, at 340 (1977); S. REP. NO. 95-989, at 54-55 (1978)).

[2028] 11 U.S.C. § 362(a) (1994). *See id.* § 101(15), (27).

[2029] *Id.* § 105, 362(h).

departure from the rule.[2030] In the absence of an exception, creditors seeking to enforce their prepetition rights or otherwise proceed against the debtor or property of the bankruptcy estate must seek court-ordered relief from the automatic stay.[2031] The breadth of the automatic injunctive power of the stay requires certain automatic exceptions to its provisions. These exceptions are narrowly-tailored to preserve the estate without hindering, for example, the exercise of a government's police and regulatory power.[2032]

The right of setoff is equitable in origin and designed to facilitate the adjustment of mutual obligations, thereby avoiding "the absurdity of making A pay B when B owes A."[2033] Setoff is a "common law right, which belongs to every creditor, to apply the unappropriated moneys of his debtor, in his hands, in extinguishment of the debts due to him."[2034] The historical antecedents of setoff rights are long and venerable.[2035] However, the right of setoff also arguably creates an "unrecaptured preference."[2036]

[2030] *Id.* § 362(b)(1)-(18).

[2031] *Id.* § 362(d) (providing that the bankruptcy court may fashion relief in appropriate circumstances "after notice and a hearing" by "terminating, annulling, modifying or conditioning" the stay). *See* FED. R. BANKR. P. 4001.

[2032] *See* 11 U.S.C. § 362(b)(4) & (5) (1994).

[2033] Studley v. Boylston Nat'l Bank, 229 U.S. 523, 528 (1913). "'In the absence of a recognition of the right to a setoff, the creditor might be forced to pay in full the amount owed to the debtor, but be limited to no more than a pro rata recovery of his claim against the debtor. The process of imposing this loss on an otherwise innocent party has historically been thought to be improper.'" *In re* Braniff Airways, Inc., 42 B.R. 443, 448 (Bankr. N.D. Tex. 1984) (quoting NORTON BANKR. L. & PRAC. § 33.01).

[2034] Gratiot v. United States, 40 U.S. (15 Pet.) 336 (1841).

[2035] *See* 5 COLLIER ON BANKRUPTCY ¶ 553.02[2], at 553-10 (Lawrence P. King et al. eds., 15th ed. 1996).

> [A] right of setoff is a remedy that has long been recognized and enforced in the commercial world at large, as well as under everyone of the nation's bankruptcy acts. . . . The Bankruptcy Code recognizes the significance of the right and continues the practice of preserving it, in part as a matter of essential fairness, but importantly in recognition of the right as part of the bundle of substantive rights that may comprise a creditor's claim.

Id.

[2036] John C. McCoid II, *Setoff: Why Bankruptcy Priority*, 75 VA. L. REV. 15, 17 (1989) (arguing that the right of setoff, though limited in bankruptcy, is at "odds with the principle of

Section 553(a) of the Bankruptcy Code preserves setoff rights in bankruptcy.[2037] Additionally, section 506(a) provides that a creditor who holds a valid setoff right is treated as a secured creditor to the extent of that right.[2038] Although the Code recognizes the right of creditors to setoff mutual, prepetition obligations, a creditor's ability to exercise that right is expressly made subject to the automatic stay.[2039]

In a significant number of consumer cases, individual debtors are entitled to receive income tax refunds for prepetition periods while, at the same time, are in arrears on prepetition tax obligations for different taxable periods. The validity and amount of the tax claims are generally not disputed by the trustee or taxpayers in most instances. The taxing authorities in such circumstances where there is no dispute have valid setoff rights under nonbankruptcy law and, absent the intervention of bankruptcy, routinely adjust the mutual obligations between the parties and apply income tax refunds against other tax liabilities in the ordinary course.[2040] Setoff of tax

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creditor equality" and unsecured creditors with a right of setoff should be treated differently from other unsecured creditors).

[2037] Section 553 of the Code provides in pertinent part:

> Except as otherwise provided in this section and in sections 362 and 363 of the title, this title does not affect any right of a creditor to offset a mutual debt owing such creditor to the debtor that arose before the commencement of the case under this title against a claim of such creditor against the debtor that arose before the commencement of the case . . . .

11 U.S.C. § 553(a) (1994). It is significant to note that § 553 does not itself create any right of setoff; rather, the provision merely recognizes and preserves the right of setoff *if* such a right exists under nonbankruptcy law. Four conditions must generally exist in order for the Code to recognize the right of a creditor to setoff an obligation it owes to one that it is owed: (1) the creditor must hold a "claim" against the debtor that arose prior to the commencement of the case; (2) the creditor must owe a "debt" to the debtor that also arose prior to the commencement of the case; (3) the claim and debt must be "mutual;" and (4) the claim and debt must each be valid and enforceable. 5 COLLIER ON BANKRUPTCY ¶ 553.01[1], at 553-7 (Lawrence P. King et al. eds., 15th ed. 1996).

[2038] 11 U.S.C. § 506(a) (1994).

[2039] *Id.* § 362(a)(7). The United States Supreme Court has recently ruled that while the act of setoff is subject to the automatic stay, placing an "administrative freeze" on an account in order to preserve the right to setoff does not violate the statutory stay. *See* Citizen's Bank of Maryland v. Strumpf, 116 S. Ct. 286 (1995). For a discussion of *Strumpf* in the tax context, see MCQUEEN & WILLIAMS, *supra* note 1971, at § 5:15.

[2040] *See* I.R.M. § 57(13)3.142(3)(b). Indeed, tax overpayments are routinely and systematically credited by the Internal Revenue Service against outstanding tax liabilities outside the context of bankruptcy. *See* 26 U.S.C. § 6402(a) (1994). A notice that the overpayment is credited

claims outside bankruptcy provides both an inexpensive and efficient means of reconciling tax liabilities and refunds. Setoff rights thus grant significant collection leverage to taxing authorities. The result in bankruptcy, however, is different.[2041]

After a consumer debtor files for relief under the Bankruptcy Code, a taxing authority is required to seek relief from the automatic stay on a case-by-case basis if it wants to offset a refund against past due taxes even if its claim is not disputed. The cost to the government of prosecuting often uncontested and routine motions as a prerequisite to enforcing an undisputed, mutual obligation is substantial. The additional penalties and interest that continue to accrue in individual cases due to the government's inability promptly to apply income tax refunds against prior period tax obligations in the ordinary course also can cause individual debtors undue hardship because of the nondischargeable nature of many tax claims.

The Recommendation grants taxing authorities the ability to setoff an income tax refund that arose prepetition against a Chapter 7 or Chapter 13 debtor against an undisputed income tax liability. The Recommendation would reduce the burden on federal, state, and local governments, conserve judicial resources now expended on resolving routine motions, facilitate prompt administration of bankruptcy cases, and reduce debtor hardship. Indeed, a number of districts have, by local rule or standing order, authorized governmental units to setoff income tax refunds against tax claims as a matter of course, thus obviating the need for a formal motion and hearing.[2042] As

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against a tax liability is automatically issued to taxpayers by the Internal Revenue Service.

[2041] When the Internal Revenue Service receives notice of a bankruptcy proceeding:

> routine offsets by the computer at the [IRS] Service Center are prevented by input of a freeze code. The actions taken by the IRS with respect to the overpayment vary depending upon the judicial district. In most judicial districts, the overpayment is simply frozen and remains so until court action is initiated by the IRS or the debtor and/or trustee. IRS instructions provide that these cases may be referred to counsel for lifting of the automatic stay so the amount can be collected by setoff during the pendency of the bankruptcy.

FINAL REPORT OF THE TAX ADVISORY COMMITTEE TO THE NATIONAL BANKRUPTCY REVIEW COMMISSION, App.at 63 (Aug. 1997) [hereinafter TAX ADVISORY REPORT]. This Report can be found in the Appendix.

[2042] *See, e.g.,* BANKR. CT. D. ARIZ. GEN. ORDER NO. 8 (automatically modifying the automatic stay so that the IRS can make setoffs against tax refunds in the ordinary course of business in Chapter 13 cases); BANKR. CT. D. S.D. IND. L. RULE B-6011 (IRS can setoff prepetition tax claims against prepetition tax refunds, subject to review on motion of party in interest); BANKR. CT. D. MINN. L. RULE 1210 (refunds can be setoff against income taxes in the ordinary course of business in any chapter); BANKR. CT. E.D.N.C. L. RULE 4001.1 (refunds can be setoff against taxes due the United States in Chapter 7 and Chapter 13 cases); BANKR. CT. M.D.N.C. L. RULE 4001 (refunds or

a result of the adoption of the Recommendation, such local rules and standing orders will no longer be necessary, and should be repealed in the interest of uniformity. The Tax Advisory Committee considered this Recommendation and a number of other options.[2043]

Competing Considerations. Exceptions to the stay must be narrowly tailored to accomplish their objective without nullifying the effect of the automatic stay. Specific setoff exceptions to the automatic stay already exist.[2044] Outside these limited exceptions, all creditors must seek relief from the automatic stay prior to a effecting a setoff on a prepetition debt. Arguably, taxing authorities should not be treated differently from other creditors. In addition, disputes over improper setoffs are costly and those costs will be borne by the other creditors. To the extent the governmental unit is a state government, under *Seminole*, these disputes may have to be brought in state court and will be even costlier to litigate.[2045]

The Recommendation is designed to mitigate these competing concerns. Setoff under the Recommendation is limited to income tax claims of federal, state and local taxing authorities who have valid, prepetition setoff rights in individual cases filed under Chapter 7 or 13 and is applicable *only* if the prepetition tax claim of the government is truly undisputed.

Police and Regulatory Exception under 11 U.S.C. § 362(b)(4) & (b)(5)

In conjunction with its review of issues relating to governmental entities, the Commission discussed a proposal to expand the police and regulatory exception under

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overpayments may be setoff against federal or state taxes due in Chapter 7 and Chapter 13 cases); BANKR. CT. D. MD. L. RULE 25 (IRS and state taxing authorities can effectuate setoffs against tax refunds owed to individual debtors in Chapter 7, 12, or 13 cases, provided the claim is filed and the claim is not disputed or has not been disallowed by another court).

[2043] The Tax Advisory Committee considered and voted on several options in addition to the current Recommendation with respect to the setoff of tax refunds and the automatic stay including: (i) a proposal that would modify the automatic stay to permit the Internal Revenue Service to effectuate a setoff of tax refunds against prepetition tax claims and postpetition nondischargeable tax claims; (ii) a proposal that no change in the law is necessary; and (iii) a proposal that would overrule all standing orders providing automatic relief from the stay and render the stay apply to setoffs. TAX ADVISORY REPORT, *supra*, note 2041, at 63-66.

[2044] *See* 11 U.S.C. § 362(b)(6) (1994) (permitting a limited setoff right to certain securities contract counter parties); *and* 11 U.S.C. § 362(b)(7) (1994) (limited setoff right for repo participants).

[2045] For a complete discussion of the effect of the Supreme Court's decision in *Seminole Tribe of Florida v. Florida*, see Report, at 3.4.

section 362(b)(4) and (b)(5).[2046] The Commission considered a number of alternative proposals to amend the police and regulatory exception in section 362(b)(4) and(b)(5).[2047] The Commission did not recommend any change to current

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[2046] The Commission had three separate discussions on this issue. The first took place on September 18, 1996 in Santa Fe, New Mexico where the Commission met in conjunction with the annual bankruptcy meeting of the National Association of Attorneys General. The second discussion took place in San Diego, California on October 19, 1996, and the third discussion took place in Detroit, Michigan on June 20, 1997.

[2047] At the Commission's meeting in Santa Fe, New Mexico, in September, 1996, government representatives including representatives of the Department of Justice, the National Association of Attorneys General, the Securities and Exchange Commission, as well as representatives of individual state attorneys general, highlighted certain gaps in the application of section 362(b)(4). Specifically, the government representatives argued that some courts do not permit a governmental unit to "exercise control over property of the estate." For example, a governmental unit would have to seek court permission before it could revoke a debtor's license for an ongoing infraction. In response, the Commission considered a proposal to amend section 362(b)(4) to except from the automatic stay the exercise of control over property of the estate in a police or regulatory action. The proposal provided a specific amendment to section 362(b)(4):

11 U.S.C. § 362(b)(4) should be amended to read as follows:

(b) the filing of a petition under section 301, 302, or 303 of this title, or of an application under section 5(a)(3) of the Securities Investor Protection Act of 1970, does not operate as a stay -

. . .

(4) under subsection (a)(1) of this section, of the commencement or continuation of an action or proceeding by a governmental unit to enforce such governmental unit's police and regulatory power, including an act to exercise control over property of the estate.

The Department of Justice and Karen Cordry, Bankruptcy Counsel for the National Association of Attorneys General, submitted an alternative proposal to the Commission that would amend section 362(b)(4) to include the following acts -

- the commencement or continuation of a proceeding against the debtor (included under current section 362(b)(4));
- the enforcement against the debtor or property of the estate of a judgment obtained prepetition (included under current section 362(b)(5));
- any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate (additional provision);
- any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the case (additional provision).

Sections 105, 362 Protection of Governmental Police and Regulatory Powers" Proposal submitted by the Department of Justice and Karen Cordry, at 2, dated January 17, 1997 (hereinafter cited as "DOJ/NAAG Proposal").

The DoJ/NAAG Proposal differs from the Commission's proposal in two primary ways. First, the DOJ/NAAG proposal would authorize a government unit to seize property as well as to

law. This discussion is provided to illuminate the issues raised by a proposed amendment to the police and regulatory power in the Bankruptcy Code as part of the Chemical Weapons Implementation Act of 1997, which is pending at the time of the Commission's Report.[2048]

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exercise control over property. Second, the proposal would allow government agencies to pursue actions "to collect, assess, or recover a claim against the debtor that arose before the commencement of the case under this title," currently stayed by section 362(a)(6), without seeking stay relief from the bankruptcy court. Because the language of section 362(a)(6) is so broad, it was reasoned, section 362(a)(6) arguably "puts every creditor into a stay violation" even if the activity appears to fit the section 362(b)(4) exception. *See In re* Mateer, 205 B.R. 915, 921 (C.D. Ill. 1997) (although section 362(a)(6) facially appears to apply to any act, such a reading would render section 362(b)(4) meaningless; subsection (a)(6) was intended to stay non-police and regulatory extra-judicial collection activities, not actions that are permitted under section 362(b)(4)).

The proponents of this proposal also asserted that the Commission's proposal should include corollary amendments to section 362(b)(5). Without similar language in section 362(b)(5), they argued that the government potentially would not be able to control or seize property of the estate on account of a prepetition judgment. *See* Letter of J. Christopher Kohn to Brady C. Williamson, at 7, dated December 12, 1996 (on file with the National Bankruptcy Review Commission).

The Department of Justice also argued that its proposed amendment would clarify that a government entity can go forward on a civil forfeiture action without the interference of the bankruptcy court. *Id.* However, as discussed, *infra*, some courts have not found civil forfeiture actions to be police and regulatory actions; conceivably, an expansion of the exception to the automatic stay would not affect the outcome in these courts.

In response to the DOJ/NAAG Proposal as well as the Commission proposal, other parties in interest have argued that bankruptcy courts can resolve lift stay actions expeditiously and therefore it is not an undue burden on government entities to require them to have the stay lifted before they take final acts to control property of the estate. *See* The Commercial Law League of America, Position Paper in Response to Working Group Proposal to Amend Section 362(b)(4), at 4 (June 1997) ("Often times actions contemplated by the Government exceed the scope of the limited exceptions to the automatic stay set forth in Section 362(b)(4) of the Code. The Government should not be allowed to make these determinations in a vacuum, but rather the Court must be able to assess each case on its facts and find that the actions contemplated by the Government relate primarily to enforcement of its regulatory power and not protection of its pecuniary interests or represent an attempt to control property of the estate."); Bernard Shapiro, Chair, Statement of the National Bankruptcy Conference, at 7 (January 22-23, 1997) ("It would be unwise to broaden this exception to permit a governmental unit to exercise its police or regulatory power to seize, interfere, or otherwise exercise control over assets of the debtor outside the protective context of a court proceeding."). Thus, these groups conclude that an expansion of section 362(b)(4) is not necessary and supplies additional leverage to government entities by providing greater leeway to pursue pecuniary actions without court authority or supervision.

[2048] Chemical Weapons Implementation Act of 1997, S. 610 (May 23, 1997).

The filing of a bankruptcy petition creates an automatic stay under section 362(a) that enjoins the initiation or continuation of civil actions that affect the debtor or property of the estate. This automatic stay applies to all parties, including government entities. A government entity that seeks to proceed with an action against the debtor or property of the estate has two potential options. First, the Bankruptcy Code provides exceptions to the automatic stay for certain types of government actions; an action that fits one of these exceptions can proceed without leave of the bankruptcy court. Second, for actions outside the scope of those exceptions, the government can seek permission from the bankruptcy court to go forward by bringing a motion for relief from the automatic stay.[2049]

Section 362(a)(1) of the Bankruptcy Code provides that the filing of a bankruptcy petition stays "the commencement or continuation, including the issuance or employment of process, of a judicial, administrative, or other action or proceeding against the debtor that was or could have been commenced before the commencement of a case under this title, or to recover a claim against the debtor that arose before the commencement of the case under this title."[2050] Section 362(b)(4) provides an exception to section 362(a)(1) and permits a government unit to commence or continue an action against a debtor to enforce such government unit's police or regulatory power without obtaining permission from the bankruptcy court.[2051] The legislative history indicates that Congress created this carve-out to permit the continuation of proceedings by governmental units to "stop violation of fraud, environmental protection, consumer protection, safety, or similar police or regulatory laws."[2052]

[2049] 11 U.S.C. § 362(d) (1994). *See also* KAREN CORDRY, BANKRUPTCY LAW AND THE GOVERNMENTAL REGULATORY PROCESS, n.33 (LRP Publications 1995). "It is important to always remember that to say that an action is stayed does not mean that the government will be forever barred from acting. It merely means that the government will need to seek relief from the stay from the bankruptcy court. In view of the appropriate deference to be granted to state proceedings, obtaining such relief should not necessarily be difficult to obtain." *Id.*

[2050] 11 U.S.C. § 362(a)(1) (1994).

[2051] "The filing of a petition . . . does not operate as a stay under subsection (a)(1) of this section, of the commencement or continuation of an action or proceeding by a governmental unit to enforce such governmental unit's police or regulatory power." 11 U.S.C. § 362(b)(4) (1994). *See also* Board of Governors of the Federal Reserve System v. MCorp Financial, Inc., 112 S. Ct. 459 (1991) (section 362(b)(4) excepted from stay Federal Reserve Board's administrative proceedings against debtor). The Supreme Court was "not persuaded . . . that the automatic stay provisions have any application to ongoing, nonfinal administrative proceedings." *Id.* at 464. Similarly, section 362(b)(5) permits the enforcement of a prepetition judgment obtained in a police or regulatory action against the debtor or against property of the estate. 11 U.S.C. § 362(b)(5) (1994).

[2052] H.R. REP. NO. 95-595, at 342-43 (1977); S. REP. NO. 95-989, at 51-52 (1978).

The language of section 362(b)(4) does not give government entities unlimited ability to go forward without bankruptcy court permission. Because section 362(b)(4) provides an exception only to actions that fall under section 362(a)(1), a literal interpretation would imply that section 362(b)(4) exempts only actions against the debtor, not against property of the estate. Taking the literal reading one step further, section 362(b)(4) would appear to stop short of permitting the actual exercise of control over property of the estate, which generally is stayed under section 362(a)(3).[2053]

The circuit courts and some lower courts, that have addressed this issue have not adopted the literal construction. Some courts interpret this provision to provide broad automatic authorization for police and regulatory actions to proceed against both a debtor and property of the estate, as is illustrated by the recent decision of the Court of Appeals for the Sixth Circuit in *Javens v. City of Hazel Park*.[2054]

In *Javens*, the court found that the automatic stay did not prevent a municipality from condemning and demolishing three of the debtor's buildings without bankruptcy court permission.[2055] The court rejected the debtors' argument that the government had acted in violation of the automatic stay under section 362(a)(3) by destroying the buildings. By interpreting the section 362(a)(1) and (a)(2) provisions as effectively permitting a government unit to exercise of control over property of the estate, the Sixth Circuit found the language in these sections and section 362(a)(3) to be a distinction without a difference.[2056] The *Javens* court concluded that the police and regulatory exceptions "are not intended to be limited to non-destructive exercises of governmental power. Many governmental actions clearly within the police or regulatory power destroy some or all of the value that property has to an estate."[2057] The Sixth Circuit relied in part on the fact that

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[2053] 11 U.S.C. § 362(a)(3) stays "any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate." Congress added the "exercise control over" language in the Bankruptcy Amendments and Federal Judgeship Act of 1984. *See* 2 Collier on Bankruptcy ¶ 362.04[3] (Lawrence P. King et al. eds. 15th ed. 1996).

[2054] 107 F.3d 359, 370 (6th Cir. 1997).

[2055] *See, e.g.*, Javens v. City of Hazel Park *(In re* Javens), 107 F.3d 359, 370 (6th Cir. 1997) (affirming district court and bankruptcy court holdings that demolition of debtor's condemned property was a proper exercise of city's police and regulatory power; "the (b)(4) and (b)(5) exceptions are not intended to be limited to non-destructive exercises of governmental power. Many governmental actions clearly within the police or regulatory power destroy some or all of the value that property has to an estate").

[2056] *Id.* at 367.

[2057] *Id.* at 370.

numerous police and regulatory statutes are *in rem* actions that require control over property to enforce; thus, it concluded that section 362(a)(1), and, consequently section 362(b)(4), were not limited to *in personam* actions.[2058]

Other courts have adopted a similar interpretation and have concluded that section 362(b)(4) permits government agencies to exercise control over property of the estate to enforce police or regulatory powers without seeking bankruptcy court permission.[2059]

However, some lower courts have read section 362(b)(4) literally and thus have held that section 362(a)(3) stays government attempts to exercise control over

[2058] "Numerous governmental aims falling plainly within the police and regulatory power are enforced by means of actions *in rem*." *Id.*, *citing* 7 U.S.C. § 136k(b) (authorizing in rem proceedings to seize adulterated or mislabeled pesticides); 15 U.S.C. § 1195(b) (authorizing same, with respect to goods in violation of Flammable Fabrics Act); M.C.L.A. 289.711 (authorizing detention, embargo, and condemnation of adulterated or mislabeled food). If actions under these provisions were not excepted from the automatic stay, the purpose of section 362(b)(4) would be grossly compromised. *Id.*

[2059] *See, e.g.*, Cournoyer v. Lincoln, 790 F.2d 971 (1st Cir. 1986) (section 362(b)(4) exempts town's removal of used truck parts from debtors' property, which had violated zoning ordinance); *In re* Yellow Cab Cooperative Ass'n, 200 B.R. 237 (D. Colo. Sept. 12, 1996) (reversing bankruptcy court's order enjoining public utilities commission from prohibiting debtor from transferring taxis to another company); *In re* Universal Life Church, Inc., 191 B.R. 433, 442 (E.D. Cal. 1995) (automatic stay does not bar revocation of tax-exempt status); Carr and Company Investments, Ltd. v. St. Tammany Parish Policy Jury, No. 88-0542, 1989 WL 65530 (E. D. La. June 13, 1989) (property rezoning exempted from stay under section 362(b)(4)); *In re* Heritage Village Church & Missionary Foundation, Inc., 87 B.R. 401, 404 (D.S.C. 1988) (section 362(b)(4) precludes bankruptcy court from enjoining revocation of debtor's tax-exempt status), *aff'd*, 848 F.2d 104 (4th Cir. 1988); Vaspourakan, Ltd. v. Licensing Bd. for the City of Boston, 85 B.R. 189 (D. Mass. 1988) (board's refusal to transfer liquor license to debtor not stay violation); *In re* Synergy Development Corp., 140 B.R. 958 (Bankr. S.D.N.Y. 1992) (not stay violation to withhold debtor's license to operate health club for failure to post bond); *In re* Edwards Motor Home Sales, Inc., 119 B.R. 857 (Bankr. M.D. Fla. 1990) (state permissibly revoked mobile home dealer license for failure to be bonded); *In re* Christmas, 102 B.R. 447, 460 (Bankr. D. Md. 1989) (revocation of debtor's horse trainer license excepted from stay under section 362(b)(4)).

See also In re Gull Air, Inc., 890 F.2d 1255 (1st Cir. 1989) (nondiscretionary automatic termination of right to use landing slots under "use or lose" provision due to post-petition non-use did not violate section 362(a)(3)); *In re* Grace Coal Co., 155 B.R. 5 (Bankr. E.D. Ky. 1993) (debtor enjoined from mining without operating permit pursuant to 28 U.S.C. § 959(b)); Colonial Tavern, Inc. v. Byrne (*In re* Colonial Tavern), 420 F. Supp. 44 (D. Mass. 1976) (under Bankruptcy Act, bankruptcy court could not enjoin city licensing board from suspending debtors' liquor licenses).

property of the estate.[2060] Courts taking this view expect government entities to seek relief from the stay before controlling or seizing property.

Even if section 362(b)(4) extends to actions to control property of the estate, as the weight of the case law suggests, it only extends to those actions that are "police and regulatory."[2061] As the phrase has been interpreted, "police and regulatory" does not refer only to actions dealing with imminent and identifiable harm or urgent public necessity.[2062] However, government agencies cannot use section 362(b)(4) to enforce contractual rights without seeking automatic stay relief,[2063] nor can they revoke a license as a means to collect a debt from the debtor or to advance the pecuniary

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[2060] *See, e.g.*, *In re* Draughon Training Institute, Inc., 119 B.R. 921 (Bankr. W.D. La. 1990) (although school license revocation proceeding was within section 362(b)(4) exception, actual revocation of school license violated automatic stay); *In re* Cattle Congress, Inc., 179 B.R. 588 (Bankr. N.D. Iowa 1995) (revocation of gaming facility license violated automatic stay), *remanded on other grounds*, 91 F.3d 1113 (8th Cir. 1996). *Accord* Hillis Motors, Inc. v. Hawaii Automobile Dealers Ass'n, 997 F.2d 581 (9th Cir. 1993) (holding that section 362(b)(4) does not except acts that are described by section 362(a)(3), although also holding that commerce department's action of dissolving corporation was not police or regulatory action). *See also In re* Horizon Air, Inc., 156 B.R. 369 (N.D.N.Y. 1993) (district court issuing temporary restraining order against F.A.A. revocation of flight operating license for alleged safety violations pending resolution of preliminary injunction hearing).

[2061] *See, e.g.*, *In re* University Medical Center, 973 F.2d 1065 (3d Cir. 1992) (withholding Medicare payments was enforcement of contractual rights, not police and regulatory action, and violated automatic stay); *In re* Farmer's Market, Inc., 792 F.2d 1400, 1403 (9th Cir. 1986) (refusal to transfer liquor license due to nonpayment of taxes violated automatic stay); *In re* Corporacion de Servicios Medicos Hospitalarios de Fajardo, 805 F.2d 440 (1st Cir. 1986) (department of health's revocation of debtor's operating license was not police and regulatory action, but was contractual action); *In re* North, 128 B.R. 592 (Bankr. D. Vt. 1991) (state suspension of chiropractor's license to compel debtor to pay taxes was not within police and regulatory powers); *In re* Massenzio, 121 B.R. 688 (Bankr. N.D.N.Y. 1990) (insurance department's revocation action against debtor was triggered by debtor's failure to pay debt and violated stay); *In re* St. Louis South Park II, Inc., 111 B.R. 260 (Bankr. W.D. Mo. 1990) (forfeiture of nursing home debtor's certificate of need not police and regulatory action, violated stay); Island Club Marina Ltd. v. Lee Co., Fla., 32 B.R. 331, 336 (Bankr. N.D. Ill. 1983) (due to lack of evidence that agency's withdrawal of building permit was pursuant to police and regulatory power, violated stay). *See also In re* Medicar Ambulance Co., Inc., 166 B.R. 918 (Bankr. N.D. Cal. 1994) (suspension of Medicare payments not police and regulatory action, violated stay). *Cf. In re* Orthotic Center, Inc., 193 B.R. 832 (N.D. Ohio 1996) (Medicare overpayments not property of estate, but if they were, suspension would not violate stay because it was within police and regulatory powers).

[2062] *See In re* Crockett, 204 B.R. 705 (Bankr. W.D. Tex. 1997), *citing In re* Commonwealth Oil Refining Co., 805 F.2d 1175 (5th Cir. 1986), *cert. denied*, 483 U.S. 1005 (1987).

[2063] *In re* University Medical Center, 973 F.2d 1065, 1074 (3d Cir. 1992) (withholding Medicare payments not police and regulatory), *citing In re* Corporacion de Servicios Medicos Hospitalarios, 805 F.2d 440, 445 (1st Cir. 1986).

interest of the government or a third party without permission in advance from the bankruptcy court.[2064]

A government agency could, however, revoke a license for noncompliance with safety standards. The bankruptcy court is not expected to look behind every exercise of police and regulatory authority to determine its legitimacy,[2065] but can assess whether a government unit has exercised its police and regulatory power in bad faith.[2066] Police and regulatory power is thus limited to government actions taken as keeper of the peace or as regulator, but not as general creditor. By limiting government action under the automatic stay to these specific functions, the Bankruptcy Code preserves equality of treatment of all creditors.

Courts generally use one of several similar tests to discern the nature of the government's action. Using the "pecuniary purpose test," a court assesses whether a proceeding relates primarily to the protection of the government's pecuniary interest.[2067] A government unit protecting its interests as a creditor is not exercising a police or regulatory power and therefore the action is stayed under the Bankruptcy Code. The "public policy test" focuses on whether the proceedings are intended to effectuate public policy or whether they are adjudications of private rights.[2068]

[2064] *See* Ohio v. Kovacs, 105 S. Ct. 705 (1985).

[2065] *See* Board of Governors of the Federal Reserve System v. MCorp Financial, Inc., 502 U.S. 32, 40 (1991).

[2066] *See* Javens v. City of Hazel Park (In re Javens), 107 F.3d 359, 365 (6th Cir. 1997), *citing In re* National Hospital and Institutional Builders Co., 658 F.2d 39, 43 (2d Cir. 1981), *cert. denied*, 454 U.S. 1149 (1982).

[2067] Eddleman v. United States Dep't of Labor, 923 F.2d 782, 791 (10th Cir. 1991); United States v. Nicolet, Inc., 857 F.2d 202 (3d Cir. 1988). "The terms 'police and regulatory power' as used in those exceptions refer to the enforcement of state laws affecting health, morals, and safety but not regulatory laws that directly conflict with the control of the res or property of the bankruptcy court." Hillis Motors, Inc. v. Hawaii Automobile Dealers' Ass'n, 997 F.2d 581, 591 (9th Cir. 1993), *citing* State of Missouri v. United States Bankr. Ct. for the E.D. of Ark., 647 F.2d 768, 776 (8th Cir. 1981), *cert. denied*, 102 S. Ct. 1035 (1982) (state liquidation of grain warehouse violated stay). One court has offered a slight variation on the pecuniary purpose test: "as a general matter, section 362(b)(4) does not include governmental actions that would result in a *pecuniary advantage* to the government vis-à-vis other creditors of the debtor's estate." *In re* Commonwealth Companies, Inc., 913 F.2d 518, 523 (8th Cir. 1990) (emphasis added).

[2068] NLRB v. Edward Cooper Painting, Inc., 804 F.2d 934 (6th Cir. 1986); *In re* Medicar Ambulance Co., Inc., 166 B.R. 918 (Bankr. N.D. Cal. 1994) (considering whether action is attempt to prevent future violations of law or attempt to determine liability of private parties); *In re* Straight, 209 B.R. 540 (D. Wyo. 1997) (decertification of debtor in disadvantaged business program violated stay because not done to promote public safety).

The scope of police and regulatory actions and the application of section 362(b)(4) regarding property of the estate is even less clear in the context of civil forfeiture actions. Civil forfeiture actions are *in rem* actions for remedial civil sanctions.[2069] Unlike criminal forfeiture actions, they are not predicated on the outcome of a criminal trial. Federal and state statutes authorize government agents to seize property, including fungible property.[2070] The government entity must simply initiate a civil forfeiture proceeding. A forfeiture judgment is a final adjudication of rights of all claimants to the property and establishes the government's unencumbered title to the property. The government's title to the property ultimately relates back to the date of the original offense, although relation back does not occur until the final adjudication proceeding.[2071] Many forfeiture statutes enable co-owners and lienholders to file claims in the forfeiture action. However, not all statutes authorizing forfeitures have "innocent owner" defenses.[2072] In addition, there generally is no formal recognition of claims of *unsecured* creditors in judicial forfeiture proceedings.

The law is not settled on whether civil forfeiture actions initiated prepetition can go forward without bankruptcy court permission under section 362(b)(4). The answer is partly dependent on whether property seized prepetition is property of the estate at all,[2073] although that has not been the central inquiry in the few published opinions that have discussed this issue. Assuming that the bankruptcy estate holds at least some interest in property seized prepetition, discussions of whether forfeiture proceedings are excepted from the automatic stay primarily have focused on whether a forfeiture proceeding is a police or regulatory action that properly fits the scope of

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[2069] *See* United States v. Ursery, 116 S. Ct. 2135, 2142 (1996) (*in rem* civil actions not punishment for purposes of Double Jeopardy Clause).

[2070] *See* 18 U.S.C. § 984 (1995) (authorizing forfeiture of fungible property, such as cash or monetary instruments).

[2071] *See* United States v. 92 Buena Vista Ave., 113 S. Ct. 1126, 1137 (1993).

[2072] *See, e.g.*, Bennis v. Michigan, 116 S. Ct. 994 (upholding Michigan statute allowing car to be forfeited as abatable nuisance after husband engaged services of prostitute in car, notwithstanding state's failure to reimburse husband's wife's part ownership interest), *reh'g denied*, 116 S. Ct. 1560 (1996).

[2073] Because the government does not obtain title to seized property until the conclusion of the forfeiture proceeding, one might conclude that the seized property remains property of the estate. However, this remains somewhat unclear. In the context of a criminal forfeiture, one court has held that property that was seized prepetition was not property of the estate. *In re* Thena, Inc., 190 B.R. 407 (D. Or. 1995) (debtor owned only bare legal title without right of possession on property seized prepetition and subject to criminal forfeiture action). *See generally* KAREN CORDRY, BANKRUPTCY LAW AND THE GOVERNMENTAL REGULATORY PROCESS, 35 (LRP Publications 1995).

the section 362(b)(4) exception.[2074] This issue has considerable significance to other creditors of the debtor's estate, particularly when the government is seizing cash or an asset of substantial value. The question in these cases essentially boils down to whether these assets will be distributed to creditors *pro rata* or whether the assets properly belong to the government.

The Court of Appeals for the Third Circuit held that a civil forfeiture action resulting from the seizure of cash was excepted from the automatic stay under section 362(b)(4).[2075] The Third Circuit explicitly rejected narrow interpretations of "police and regulatory" and reasoned that "a civil forfeiture action is an action by a governmental unit to enforce its police or regulatory power to combat the problem of illicit drugs" though neither the debtor nor her associates faced drug- related charges in this case.[2076] Several other courts have endorsed the Third Circuit's holding.[2077]

Some courts have concluded that civil forfeiture actions are not within the ambit of the government's police and regulatory power when they do not vindicate or secure the public welfare.[2078] Courts also have expressed concern that in the

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[2074] One commentator has noted that "it must be recognized that [civil forfeiture] is, essentially, asserting a right to a claim for a penalty. To the extent the [Bankruptcy] Code subordinates collections of such a penalty, that same principle may well be applied to any request by the government to enforce the forfeiture." CORDRY, *supra*, note 2073, at 35.

[2075] *In re* James, 940 F.2d 46, 51 (3d Cir. 1991) (bankruptcy court erroneously vacated state forfeiture judgment on $7,990 in cash found in car).

[2076] *Id*., 940 F.2d at 47, 51.

[2077] *See, e.g.*, Smith v. Alabama, 176 B.R. 221 (Bankr. N.D. Ala. 1995) (following *James* with no discussion, holding that state forfeiture proceeding against mobile home and real estate was not stayed); Boricua Motors Leasing Corp. v. Puerto Rico, 154 B.R. 834 (D. P. R. 1993) (holding that civil forfeiture action against automobile was within police power, and debtor should not have waited a year to challenge action and seizure using section 542(a)).

[2078] *See In re* Goff, 159 B.R. 33, 40 (Bankr. N.D. Okla. 1993) (forfeiture judgment against land and mobile home of Chapter 13 debtor is stayed until discharge or until further order of court) *citing* Austin v. United States, 113 S. Ct. 2801 (1993); *In re* Ryan, 15 B.R. 514, 519 (Bankr. D. Md. 1981) (staying forfeiture action against $5,562 in cash that was found in house that also contained a bag of marijuana and water pipe). The *Goff* court suggested that a genuinely remedial forfeiture action might constitute a proper exercise of the police and regulatory power. *Goff*, 159 B.R. at 40.

See also In re Thomas, 179 B.R. 523, 528 (Bankr. E.D. Tenn. 1995) (holding that city's seizure of truck and subsequent proceedings violated automatic stay and that section 362(b)(4) is inapplicable because seizure occurred postpetition); *In re* Bridge, 90 B.R. 839, 840 n. 1 (Bankr. E.D. Mich. 1988) (stating legal proposition in footnote without discussion, and avoiding *postpetition* seizure of $670,000 worth of Canadian Treasury Bills that were traceable proceeds of debtor's

context of a bankruptcy proceeding, civil forfeiture actions do not punish the debtor, but instead punish the unsecured creditors of the bankruptcy estate. Some civil forfeiture proceedings have been described as "actions against property of the estate that resulted in a decrease of the property of the estate which will ultimately punish the creditors by enriching the seizing agency at the expense of the creditors."[2079]

In addition, some courts have found that the section 362(b)(4) exception applies only to actions against the *debtor*, and not to *in rem* civil forfeiture actions against *property*. Unlike the Sixth Circuit, these courts take a narrow and literal view of the police and regulatory exception. As such, these courts expect that government entities will seek relief from the stay before going forward in their actions against property.[2080]

As part of the Chemical Weapons Implementation Act, which passed in the Senate on May 23, 1997, section 362(b) was proposed to be amended as follows:

> (1) by striking paragraphs (4) and (5); and
> (2) by inserting after paragraph (3) the following:
> "(4) under paragraph (1), (2), (3), or (6) of subsection (a) of this section, of the commencement or continuation of an action or proceeding by a governmental unit or any organization exercising authority under the Convention on the Prohibition of the Development, Production, Stockpiling and Use of Chemical Weapons and on their Destruction, opened for signature on January 13, 1993, to enforce such governmental unit's or organization's police and regulatory power, including the enforcement of a judgment other than a money judgment, obtained in an action or proceeding by the governmental unit to enforce such governmental unit's or organization's police or regulatory power."[2081]

The language of section 603 would replace the current language of sections 362(b)(4) and (5). The Chemical Weapons legislation included this amendment because:

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husband's fraudulent transfer of ranch).

[2079] *Thomas*, 179 B.R. at 528 (section 362(b)(4) inapplicable to *postpetition* seizure and civil forfeiture actions, which also do not fit within criminal proceeding exception under section 362(b)(1)). *See also In re* Goff, 159 B.R. at 42 ("These creditors are not criminals. They are innocent, taxpaying citizens, who do not deserve to be victimized by their own State government").

[2080] *See In re* Bridge, 90 B.R. at 840, n.1; *In re* Ryan, 15 B.R. 514, 519 (Bankr. D. Md. 1981).

[2081] Chemical Weapons Implementation Act of 1997, S. 610 (May 23, 1997).

> [t]he international body which oversees enforcement of the Chemical Weapons Convention is non-governmental and therefore is not covered under the exemption. This means that under current law a bankruptcy court could issue an injunction preventing any inspection for, or seizure of, chemical weapons. If this law had not been changed, the United States would come into noncompliance with the treaty.[2082]

Given the language of the amendment, it apparently affects not only actions in connection with the Chemical Weapons Convention, but rather, would except from the stay all governmental units – federal, state, or local – and all types of actions against the debtor and against the debtor's property that may be considered police and regulatory.[2083] This legislation has been referred to the House Committee on the Judiciary.

The police and regulatory exception applies to the automatic stay only; the court retains the power to stay a police or regulatory action under section 105.[2084] The discretion of the court to enjoin police and regulatory actions is not without limitation: "[a]lthough there are limited circumstances in which a bankruptcy court may stay a state police power exercise under § 105, *there must be a finding of serious conflict between the continuance of the state action and the policies of the bankruptcy code.*"[2085] Another limitation is the fourth prong of the Rule 65 standard, requiring the court to find "that the granting of the injunction will not disserve the public."[2086] Where an injunction is sought against an ongoing state criminal

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[2082] Senator Charles Grassley, Press Release, May 23, 1997.

[2083] Electronic mail transmission from Stephen H. Case, Senior Adviser, to Commissioner John A. Gose (May 29, 1997).

[2084] *See, e.g.*, Commonwealth Oil Refining Co., Inc. v. U.S. Envtl. Protection Agency, 805 F.2d 1175, 1187 (5th Cir. 1986) (court retains discretion to stay acts exempt from the automatic stay), *cert. denied*, 483 U.S. 1005 (1987); Browning v. Navarro, 743 F.2d 1069, 1084 (5th Cir.) (same), *reh'g denied en banc*, 747 F.2d 1465 (5th Cir. 1984); State of Missouri v. U.S. Bankruptcy Court, 647 F.2d 768, 776-77 (8th Cir. 1981) (same), *cert. denied*, 454 U.S. 1162 (1982); *In re* Bel Air Chateau Hosp., Inc., 611 F.2d 1248, 1251 (9th Cir. 1979) (same).

[2085] Brennan v. Poritz (*In re* Brennan), 198 B.R. 445, 448, 450 (D.N.J. 1996) (reversing bankruptcy court decision enjoining state civil securities fraud action; "the bankruptcy code expressly exempts state actions brought under state police or regulatory powers from the automatic stay, it is only in rare cases that a § 105 injunction of a police power exercise will "carry out" the code's provisions.")

[2086] Feld v. Zale Corp. (*In re* Zale Corp.), 62 F.3d 746, 765 (5th Cir. 1995).

prosecution, or a legitimate tax collection action, courts have acknowledged that public policy strongly supports allowing the nonbankruptcy action to proceed.[2087]

The Commission also discussed the use of section 105(a) to enjoin governmental entities from exercising their police and regulatory powers. Section 105(a) permits the bankruptcy court to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions" of title 11. Power under section 105 is similar in nature to the All Writs Power granted to Article III courts under 28 U.S.C. § 1651.[2088] The pertinent legislative history of section 105 provides that "the court has ample other powers to stay actions not covered by the automatic stay. Section 105, of proposed title 11, derived from Bankruptcy Act section 2a(15), grants the power to issue orders necessary or appropriate to carry out the provisions of title 11."[2089] Section 105 can be used to fill in gaps in section 362, but "whatever equitable powers remain in the bankruptcy courts must and can only be exercised within the confines of the Bankruptcy Code.[2090]

While applied sparingly, courts have used section 105 to enjoin actions that otherwise would not be stopped by the automatic stay. For example, it may be appropriate to halt an action against a third party, such as a principal of the debtor, that would have a significant effect on the bankruptcy estate and the parties that the

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[2087] Barnette v. Evans, 673 F.2d 1250, 1251 (11th Cir. 1982) (in refusing to stay a state criminal action, court stated "There is a public interest in every good faith criminal proceeding . . . . which overrides any interest the bankruptcy court may have in protecting the financial interest of debtors."); Office of Surface Mining v. Sewanee Land, Coal & Cattle, Inc., (*In re* Sewanee Land, Coal and Cattle, Inc.), 34 B.R. 696, 702 (N.D. Ala. 1983) ("granting of the injunction harms the public's interest as it circumvents the Congressionally mandated permitting process and allows L & R to mine not only without a valid permit, but allows additionally that L & R may mine anywhere without restriction except as to performance standards."); *In re* Invesco Int'l Corp., 93 B.R. 296, 298 (Bankr. N.D. Ga. 1988) (state criminal action).

[2088] The All Writs Statute provides that "the Supreme Court and all courts established by Congress may issue all writs necessary or appropriate in aid of their respective jurisdictions and agreeable to the usages and principles of law." 28 U.S.C.§ 1651 (1996). All writs power grants courts the flexibility to address unique situations requiring process for which no statutory guidance exists. It is important to note that, like section 105, the All Writs Statute "is not an independent source of jurisdiction, but rather it grants the courts flexibility to issue orders which preserve and protect their jurisdiction." 2 COLLIER ON BANKRUPTCY ¶ 105.01, 105-3 (Lawrence P. King, et al. eds,. 15th ed. 1996).

[2089] H.R. REP. NO. 95-595, at 342 (1977), *reprinted in* 1978 U.S.C.C.A.N. at 5963, 6298.

[2090] Norwest Bank Worthington v. Ahlers, 485 U.S. 197 (1988).

estate protects, such as creditors, employees, and shareholders.[2091] Courts generally do not apply such power freely.[2092]

The majority of courts use the traditional Rule 65 standard to gauge whether to issue an injunction under section 105.[2093] While some courts suggest that a section 105 injunction should have a different premise based on the goals that underlie the bankruptcy system,[2094] other commentators agree with the tendency of the courts to apply strictly Rule 65.[2095]

Failure to establish the Rule 65 prerequisites has resulted in a denial of injunctive relief.[2096] The traditional test has been modified by some courts to more

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[2091] *See, e.g.*, Myerson & Kuhn v. Brunswick Assoc. Ltd. Partnership (*In re* Myerson & Kuhn), 121 B.R. 145 (Bankr. S.D.N.Y. 1990) (using section 105 to enjoin creditors' actions against nondebtor partners who had agreed to help fund reorganization).

[2092] *See, e.g.*, Teachers Ins. & Annuity Ass'n of America v. Butler, 803 F.2d 61 (2d Cir. 1986) (denying section 105 injunctive relief to partners of debtor).

[2093] *See, e.g.*, Feld v. Zale Corp. (*In re* Zale Corp.), 62 F.3d 746, 765 (5th Cir. 1995); American Imaging Servs., Inc. v. Eagle-Picher Indus., Inc. *(In re* Eagle-Picher Indus., Inc.), 963 F.2d 855, 858 (6th Cir. 1992); Commonwealth Oil Ref. Co. v. EPA (*In re* Commonwealth Oil Ref. Co.), 805 F.2d 1175, 1188-89 (5th Cir. 1986) ("The legislative history of § 105 makes clear that stays under that section are granted only under the usual rules for the issuance of an injunction."), *cert. denied,* 483 U.S. 1005 (1987); Whitaker v. ICC (*In re* Olympia Holding Corp.), 161 B.R. 524, 528 (M.D. Fla. 1993); Costa and Head Land Co. v. National Bank of Commerce (*In re* Costa and Head land Co.), 68 B.R. 296, 298 (N.D. Ala. 1986).

[2094] Some courts dispense with the requirements that there be no adequate remedy at law and that there be irreparable harm. *See, e.g., In re* L&S Indus., Inc., 989 F.2d 929, 932 (7th Cir. 1993) ("In other words, the court does not need to demonstrate an inadequate remedy at law or irreparable harm."); Monarch Life Ins. Co. v. Ropes & Gray, 65 F.3d 973, 978-79 (1st Cir. 1995) ("We have held that Bankruptcy Code § 105(a) confers ample power upon the bankruptcy court to enjoin the initiation or continuation of judicial proceedings in a nonbankruptcy forum against nondebtors during the pendency of a Chapter 11 case, where the court reasonably concludes that such actions would entail or threaten adverse 'impact' on the administration of the Chapter 11 estate."); *In re* Chicago, Milwaukee, St. Paul and Pacific R. Co., 738 F.2d 209, 213 (7th Cir. 1984); *In re* Chateaugay Corp., 93 B.R. 26, 29 (S.D.N.Y. 1988); Garrity v. Leffler (*In re* Neuman), 71 B.R. 567, 571 (S.D.N.Y. 1987).

[2095] 2 COLLIER ON BANKRUPTCY ¶ 105.02, 105-10 (Lawrence P. King et al. eds., 15th ed. 1996) ("Because a request for an injunction pursuant to section 105 is akin to a request for a preliminary injunction, the party seeking injunctive relief must satisfy the requirements of Rule 65 of the Federal Rules of Civil Procedure as applied to bankruptcy by Bankruptcy Rule 7065.").

[2096] *See, e.g.*, Glassman v. Electronic Theatre Restaurants Corp. (*In re* Electronic Theatre Restaurants Corp.), 53 B.R. 458 (N.D. Ohio 1985) (reversing section 105 injunction; bankruptcy court failed to establish risk of irreparable harm); *In re* Trails End Lodge, Inc., 45 B.R. 597, 601

closely fit the relevant inquiry in a bankruptcy case.[2097] Modification of the traditional standard has yielded a more flexible standard in some cases, leading courts to conclude that certain requirements, *e.g.*, the lack of an adequate remedy at law, may be unnecessary when considering whether to enjoin certain activities.[2098]

The cases reflect many instances where bankruptcy policy is rightfully subordinated to police and regulatory considerations.[2099] Section 105 injunctions in

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(Bankr. D. Vt. 1984) (court denied section 105 injunction, citing failure to meet preliminary injunction standard); Venture Prop., Inc. v. Norwood Group, Inc. (*In re* Venture Prop., Inc.), 37 B.R. 175 (Bankr. D.N.H. 1984) (lack of irreparable injury warranting denial of section 105 injunction); Wolf Financial Group, Inc. v. Hughes Construction Co. (*In re* Wolf Financial Group, Inc.), Civ. No. 94 B 44009/44010 (Bankr. S.D.N.Y. Dec. 14, 1994) (injunctive relief against NASD enforcement action denied, debtor failed to show possibility of a successful reorganization; stating, *in dicta*, that a limited exception to the irreparable harm requirement exists "where the conduct to be enjoined places the reorganization at risk or impairs the court's jurisdiction with respect to a case before it.").

[2097] *See In re* Monroe Well Service, Inc., 67 B.R. 746, 752-53 (Bankr. E.D. Pa. 1986) ("The first requirement is that there be the danger of imminent, irreparable harm to the estate or the debtor's ability to reorganize. Second, there must be a reasonable likelihood of a successful reorganization. Third, the court must balance the relative harm as between the debtor and the creditor who would be restrained. Fourth, the court must consider the public interest in successful bankruptcy reorganizations with other competing societal interests."); *see also* North Ala. Anesthesiology Group, P.C. v. Zickler (*In re* North Ala. Anesthesiology Group, P.C.), 154 B.R. 752, 764 (N.D. Ala. 1993); *In re* Environmental Waste Control, Inc., 125 B.R. 546, 551 (N.D. Ind. 1991).

[2098] "In other words, the court does not need to demonstrate an inadequate remedy at law or irreparable harm." *In re* L&S Indus., Inc., 989 F.2d, 929, 932 (7th Cir. 1993). *See also* Monarch Life Ins. Co. v. Ropes & Gray, 65 F.3d 973, 978-79 (1st Cir. 1995) ("We have held that Bankruptcy Code § 105(a) confers ample power upon the bankruptcy court to enjoin the initiation or continuation of judicial proceedings in a nonbankruptcy forum against nondebtors during the pendency of a Chapter 11 case, where the court reasonably concludes that such actions would entail or threaten adverse 'impact' on the administration of the Chapter 11 estate."); *In re* Baldwin-United Corp., 79 B.R. 321, 328 (Bankr. S.D. Ohio 1987) (stating, *in dicta*, that SEC investigation was temporarily enjoined due to drain on estate and substantial duplication with Examiner's investigation; scope of investigations were soon settled between Examiner, SEC, and parties in interest).

[2099] U.S. Dept. of Health & Human Services v. Noonan, No. 96-30064-FHF, 1996 WL 728352, *4 (D. Mass. Oct. 15, 1996) (court refuses to extend ch. 7 trustee's time to file Medicare cost reports; "Bankruptcy Court has inappropriately become entangled in construing the right and form of Medicare reimbursement, a right which remains exclusively within the domain of the Medicare Act and subject to the rules and determinations as promulgated by the Secretary of Health and Human Services."); Sturge v. Smouha (*In re* Smouha), 136 B.R. 921, 927 (S.D.N.Y.) (affirming bankruptcy court refusal to stay criminal proceedings; RICO provision precluded issuing injunction), *dismissed without opin.*, 979 F.2d 845 (2d Cir. 1992); Wilner Wood Prods. Co. v. State of Maine, Dept. of Envtl. Protection, 128 B.R. 1, 3 (D. Me. 1991) (section 105 could not override section 959(b) provision); Clark v. United States (*In re* Heritage Village Church and Missionary Fellowship), 87 B.R. 401 (D.S.C.) *aff'd*, 848 F.2d 185 (4th Cir. 1988) (Anti-Injunction Act

the police and regulatory context also are subject to *Younger* abstention considerations.[2100] When courts have enjoined police and regulatory actions, on rare occasions, they have done so to provide protection to collective interests that may not be considered in the other action. In such instances, the bankruptcy court equilibrates a variety of competing interests, including employees, other creditors, and shareholders. The burdens faced by the estate under these circumstances are usually overwhelming and require action by the court, such as to prevent the immediate loss of thousands of jobs as well as a portion of municipal transportation, or to prevent the debtor's immediate compliance with a possibly invalid but extremely burdensome claims procedure. The grounds for injunctions of police and regulatory actions have included: extraordinary circumstances,[2101] significant or unwarranted threat to estate assets as determined under the traditional preliminary injunction standards,[2102] and bad faith prosecution.[2103] Section 105 injunctions also have been issued, usually in

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prohibited section 105 injunction); United States v. Condel, Inc. (*In re* Condel, Inc.), 91 B.R. 79 (B.A.P. 9th Cir. 1988) (plan provision enjoining IRS violated Anti-Injunction Act).

[2100] *See, e.g.,* City of New York v. 1820-1838 Amsterdam Equities, Inc., 191 B.R. 18, 21 (S.D.N.Y. 1996) (reversing bankruptcy court order enjoining criminal summonses for fire code violations; the bankruptcy order "appears to violate the fundamental principles of the *Younger* abstention doctrine, which holds that federal courts should not interfere, by way of an injunction or declaration, with state or local criminal and quasi-criminal administrative proceedings, in the absence of extraordinary circumstances").

[2101] *See* Pennsylvania Public Utility Comm'n v. Metro Transp. Co., 64 B.R. 968, 972 (Bankr. E.D. Pa. 1986) (extraordinary circumstances [loss of 1500 jobs, elimination of significant portion of public transportation in city] warranted bankruptcy court stay of Commission order denying debtor's application for self-insurance on 800 taxicabs, but bankruptcy stay required debtor to comply with terms in partial settlement to safeguard public safety concerns). *See Smouha,* 136 B.R. at 927 ("It is axiomatic that 'equity will not interfere with the criminal processes, by entertaining actions for injunction or declaratory relief in advance of criminal prosecution' . . . general principle holds firm except in the most extraordinary and compelling circumstances,") *citing* Zemel v. Rusk, 381 U.S. 1, 19 (1965).

[2102] NLRB v. Superior Forwarding, Inc., 762 F.2d 695, 698 (8th Cir.) (NLRB proceeding for fifty-two unfair labor practice grievance stayed under section 105; NLRB conceded "court's authority to enjoin Board proceedings when they directly threaten the assets of the bankrupt's estate"), *reh'g denied en banc,* 120 LRRM (BNA) 2441 (8th Cir. 1985); Whitaker v. Interstate Commerce Commission (*In re* Olympia Holding Corp.), 161 B.R. 524 (M.D. Fla. 1993) (ICC stayed from requiring debtor to participate in show cause proceedings on 32,000 claims based on rules recently struck down as invalid by Third Circuit); Landmark Land Co. of Carolina v. Resolution Trust Corp. (*In re* Landmark Land Co.), 134 B.R. 557 (D.S.C. 1991) (RTC stayed from calling shareholders meeting to vote in new board of directors when evidence demonstrated that vote intended to cause shareholders to usurp creditors' rights in contravention of bankruptcy priority), *reversed on other grounds*, 973 F.2d 283 (4th Cir. 1992).

[2103] *In re* Jerzak, 47 B.R. 771, 773 (Bankr. W.D. Wis. 1985) (staying "nominally criminal" proceeding intended to bring pecuniary relief by recovering prepetition wages; criminal charges

conjunction with section 362, to stay an action that actually was pecuniary in nature.[2104]

Implications of *Seminole Tribe of Florida v. Florida*[2105]

The background of the *Seminole* opinion as well as its broader effects are discussed at length in the *Seminole* section of the report.[2106] This discussion focuses specifically on the effect of the proposed amendments to the police and regulatory exception under section 362(b)(4) and (b)(5). In *Seminole*, the Supreme Court held that the Eleventh Amendment prevents Congress, acting pursuant to its Article I powers, from abrogating a state's sovereign immunity by subjecting it to suit in federal court.[2107] The bankruptcy implication is that a state, unless it waives its Eleventh Amendment sovereign immunity, is not subject to the jurisdiction of the bankruptcy court when it is a creditor or other party in interest in a bankruptcy case.[2108]

The proposed amendments discussed above will not broaden the implications of *Seminole* and state sovereign immunity under the Eleventh Amendment. The Eleventh Amendment shields states from suit by private parties in federal court. By

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apparently based only on allegation that financially strapped debtor/employer owed wages to employee).

[2104] Hunt v. CFTC (*In re* Hunt), 93 B.R. 484 (Bankr. N.D. Tex. 1988) (balancing equities under traditional Rule 65 test, CFTC action to collect assessed damages would be stayed, and action to impose fine not stayed under section 362(b)(4)) *mod. on other grounds*, No. 388-35725, 1989 WL 67827 (Bankr. N.D. Tex. Jan. 31, 1989); Organized Maintenance, Inc. v. Ford, 47 B.R. 791, 795 (Bankr. E.D.N.Y. 1985) (Dept of Labor action was pecuniary in nature and was properly stayed), *vacated in part, dismissed in part,* 69 B.R. 295 (E.D.N.Y. 1987); Sam Daily Realty, Inc. v. Dept of Commerce and Consumer Affairs (*In re* Sam Daily Realty, Inc.), 57 B.R. 83 (Bankr. D. Haw. 1985) (entry of money judgment by government not stayed; proceeding to enforce money judgment resulting from proceeding was stayed).

[2105] 116 S. Ct. 1114 (1996).

[2106] The *Seminole* discussion is in Section 3.4.

[2107] *Seminole*, 116 S. Ct. at 1131-32 ("Even when the Constitution vests in Congress complete lawmaking authority over a particular area, the Eleventh Amendment prevents congressional authorization of suits by private parties against nonconsenting States. The Eleventh Amendment restricts the judicial power under Article III and Article I cannot be used to circumvent the constitutional limitations placed upon federal jurisdiction."). *Seminole* overruled an earlier Supreme Court case that had endorsed Congress' power to abrogate a state's sovereign immunity under the Commerce Clause in Article I. *See* Pennsylvania v. Union Gas Co., 491 U.S. 1 (1989).

[2108] The Supreme Court has not ruled directly on whether *Seminole* is applicable in a bankruptcy case.

its terms, the Eleventh Amendment does not increase a state's authority to act, it merely selects the relevant state court as the forum where private parties must enforce a state's compliance with either state or federal law.

However, if the exceptions to the automatic stay are expanded to give greater authority for government units to obtain property of the estate without seeking court permission in advance, this may lead to more frequent litigation over whether the state has properly exercised the power at issue. These actions will be brought in state court, unless the state has waived its Eleventh Amendment sovereign immunity, though what is required for a valid state waiver has been questioned by a recent Fourth Circuit case.[2109] *Ex parte Young* relief for a stay violation is unlikely, because the debtor or the trustee will rarely know that a state official is about to take action.[2110] Disputes over whether a particular act was in violation of the stay – by definition – take place after the conduct has already occurred. Thus, the hurdles for pursuing police and regulatory violations against nonconsenting state agencies will be much higher than for pursuing the same actions against federal or local agencies.

If a state, purportedly acting pursuant to its police and regulatory power, is able to take a critical piece of the debtor's business, the effect may be to shut down the debtor's business, jeopardizing going concern value and jobs, further impairing the claims of other creditors, and resulting in a liquidation of the assets. The proposed amendments expand the range of actions that a government unit (including a state government) may take without seeking relief from the automatic stay. Depending on the development of *Seminole* in the bankruptcy context, the potential consequences of expanding unilateral action by governmental units could be complicated further by shifting some of the litigation — where state governments are involved — to the state courts. All other government units, other than states, will still be subject to bankruptcy court review if their actions overstep the automatic stay exceptions discussed above.

Bankruptcy is a delicate system, balancing a variety of competing interests. Permitting one party, in this case states, to operate outside this system threatens the usefulness of bankruptcy cases and proceedings for both debtors and creditors. Given this significant downside, requiring a state to get a determination *in close cases* that

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[2109] Schlossberg v. State of Maryland (*In re* Creative Goldsmiths of Washington, D.C., Inc.), 119 F.3d 1140 (4th Cir. 1997).

[2110] *Ex parte Young,* 209 U.S. 123 (1908). An *Ex parte Young* injunction can only be issued against a state officer to prevent an ongoing constitutional rights violation for which money damages will not suffice. Once the state has acted, an *Ex parte Young* injunction is not a viable option. *See* Edelman v. Jordan, 415 U.S. 651 (*Young* permits prospective relief only), *reh'g denied,* 416 U.S. 1000 (1974).

a particular act is covered by the police and regulatory exception does not seem inequitable or unduly burdensome, even after *Seminole*.