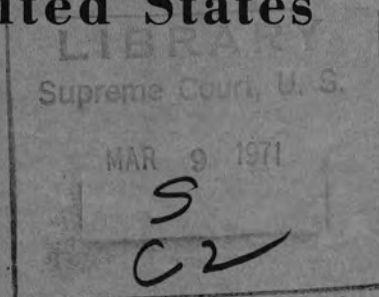


Supreme Court of the United States

OCTOBER TERM, 1970



In the Matter of:

Docket No. 125

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THE UNITED STATES OF AMERICA, :
: :

Petitioner :
: :

vs. :
: :

WILLIAM L. RANDALL, TRUSTEE, :
: :

Respondent :
: :
----- X

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Place Washington, D. C.

Date February 22, 1971

ALDERSON REPORTING COMPANY, INC.

300 Seventh Street, S. W.

Washington, D. C.

NA 8-2345

C O N T E N T S

	<u>ARGUMENT OF:</u>	<u>P A G E</u>
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	of the Petitioner	2
4	Kevin J. Gillogy, Esq., on behalf	
	of Respondent	21
5	<u>REBUTTAL:</u>	
6	Richard B. Stone, Esq.	38
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IN THE SUPREME COURT OF THE UNITED STATES

OCTOBER TERM 1970

THE UNITED STATES OF AMERICA,

Petitioner

vs

WILLIAM L. RANDALL, TRUSTEE,

Respondent

No. 125

The above-entitled matter came on for argument at
1:55 o'clock p.m. on Monday, February 22, 1971.

BEFORE:

WARREN E. BURGER, Chief Justice
HUGO L. BLACK, Associate Justice
WILLIAM O. DOUGLAS, Associate Justice
JOHN M. HARLAN, Associate Justice
WILLIAM J. BRENNAN, JR., Associate Justice
POTTER STEWART, Associate Justice
BYRON R. WHITE, Associate Justice
THURGOOD MARSHALL, Associate Justice
HARRY A. BLACKMUN, Associate Justice

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1 possession to file periodic reports and to maintain full
2 records of its operation during the arrangement period. And
3 in addition, the Referee ordered the debtor to open up three
4 bank accounts. The first of these accounts was to receive
5 all revenues received by the business during the operation in
6 the arrangement period. And the second account was to receive
7 periodically from the funds deposited in the revenues account
8 the amount necessary to pay all employee wages and disburse-
9 ments from this payroll account were to be made at proper in-
10 tervals with the approval of the Referee.

11 The Referee ordered that simultaneously with
12 meeting the debtor in possession's payroll obligation that the
13 debtor deposit into a third special account the amount of tax
14 and social security deductions that the debtor was required to
15 withhold from his employees' wages. And withdrawals from this
16 third account were to be allowed only for payment of the
17 withheld taxes and welfare benefits as those payments became,
18 due to the United States Government.

19 The debtor failed almost entirely to comply with
20 the Referee's orders, with the orders of the Bankruptcy Court
21 with respect to these withheld taxes, although the income and
22 social security taxes were withheld from the employee wages,
23 the withheld funds were not placed in a special account nor
24 were they paid over to the United States at the proper time,
25 as required by the arrangement court.

1 During the arrangement the United States filed
2 a proof of claim for \$1,075, that is one thousand, seventy-five
3 dollars of FICA and income taxes withheld from employees'
4 salaries on the ground that this amount was a special trust
5 for the United States benefit under Section 7501A of the
6 Internal Revenue Code of 1954 and about that section I shall
7 elaborate shortly.

8 Subsequently, about three months after the filing
9 of the original arrangement petition, Halo was adjudicated a
10 bankrupt. And a month later, on December 22, 1967, the United
11 States filed a petition in the bankruptcy proceeding, asking
12 that the withheld taxes which it claimed as a trust fund under
13 Section 7501 be paid over to the United States, just as any
14 trust fund would be paid over prior to payment of the costs
15 and expenses of administration of the bankruptcy proceeding.

16 And the Referee denied the Government's petition
17 and the District Court and the Court of Appeals upheld the
18 Referee's denial of the petition and it is that on which we are
19 here on a writ of certiorari to contest now.

20 Both of these courts held essentially that Halo's
21 obligation to pay over to the Government the taxes withheld
22 from employee wages was merely an administrative expense of the
23 bankrupt estate and was thereby subject to the scale of
24 priorities established by Section 64 of the Bankruptcy Act of
25 which I am sure this Court is quite familiar.

1 Now, I think it would be helpful to view the
2 issue presented here, which is whether the Government is en-
3 titled to recognition of a trust fund for the amount of taxes
4 withheld from the salaries of the bankrupt's employees during
5 the arrangement period as breaking down, essentially, into two
6 parts; two questions.

7 The first question is, and this is really the
8 question as construed by the Court of Appeals: whether the
9 trust fund concept is simply inapplicable altogether, as both
10 courts below seem to have felt, in a bankruptcy proceeding.
11 And the second question, which neither court reached, but which
12 I believe was the focus of the Bankruptcy Referee's decision,
13 is whether, assuming that the trust does not disappear merely
14 by virtue of the withholding employer's bankruptcy, but whether
15 the trust is nonetheless, defeated or enjoined if the trust is
16 defeated by virtue of the Government's inability to trace the
17 res of the trust, and I will address myself to both of these
18 questions.

19 Q As the Government looks at this case it
20 really is not a matter of priority, at all.

21 A That's right, Mr. Justice Stewart.

22 Q And by contrast, the way these courts look
23 at it, that's all it was.

24 A That's right.

25 Q Am I correct in that?

1 A That's exactly right, and prior to several
2 years ago, I believe in 1955 when the Third Circuit decided
3 the Connecticut Motor Lines case, every court that had looked
4 into this and all the commentators, as I shall show shortly,
5 viewed the question as not one of priorities, but simply a
6 recognition of a trust, and not the matter of relative priori-
7 ties.

8 Q And then the question becomes: did the
9 trust to be --

10 A Yes; is it --

11 Q -- it stood because the res --

12 A Exactly; exactly; that is precisely what
13 I think is important to show. And what we are really alarmed
14 about in this decision is the fact that the Court of Appeals
15 viewed these trust assets as debts and viewed this case as a
16 matter of priorities between conflicting administrators.

17 Q Yes.

18 A Now --

19 Q Well, it is apparently your theory that the
20 bankrupt estate is really enjoying a windfall if it prevails
21 here; is it not?

22 A That's right, Mr. Justice Blackmun, though
23 it is hard to trace, as I intend to discuss at length, it is
24 hard to trace precisely what happened to the funds, one likely,
25 logical assumption is that this trust fund has simply been added

1 to the amount of assets available for the collection of the
2 bankrupt's creditors. And therefore, collections from those
3 assets would be windfalls to those creditors.

4 Q But the trust fund you are talking about
5 in every case of this kind is a fund that arises from the
6 bankrupt's assets themselves -- from the bankrupt's own assets?

7 A That's right --

8 Q It's just something that -- he paid wages
9 but he wrote checks for his employees for an amount less than
10 what they were getting paid --

11 A That's right --

12 Q -- and so he just kept the rest. And so
13 there has never been a transfer creation of the trust fund?

14 A No; it was ordered by the Referee that the
15 Trustee make a transfer at the time he paid all the wages --
16 in fact he never did. And one of the points which I plan to
17 address myself to is whether the enjoinder of the trust ought
18 to be defeated by the fact that the Trustee never did make
19 these deposits and so that all we are really talking about is
20 whether a trust ought to be imposed on general assets of the
21 bankrupt estate. That is the question in this case, as we
22 view it.

23 But that is not the question as the Court of
24 Appeals viewed it and I think it is very important to see
25 exactly how the Court of Appeals did identify this question and

1 to make sure that what I consider the gross misconception in
2 the Court of Appeals opinion be corrected.

3 Q Well, on your theory this statute, along
4 with the order of the Court, impresses a constructive trust
5 on the total receipts of the bankrupt and regards him as having
6 done what he had been ordered to do; is that substantially --

7 A That's exactly right; that's exactly right,
8 Mr. Chief Justice. That is our theory. And that is the theory
9 of Professor Scott and that is the theory of all the courts
10 which have directed themselves to this aspect of the case and
11 the theory that the courts have gone on and since we have
12 gotten into this I might as well anticipate what I expected to
13 be a later statement of the argument: the theory that these
14 courts have gone upon is that yes, in a situation where the
15 res of a trust cannot be traced, where you are simply talking
16 about general assets, is that you run a risk in either imposing
17 the trust or disregarding the trust, you run a risk that the
18 actual proceeds have been lost in the accounting procedure;
19 there is no record to say where the assets went and so that
20 either the beneficiary of the trust or the general creditors
21 may have suffered in some way.

22 Now, it seems to me the most likely assumption is
23 that the estate has been fattened by the failure to pay over
24 these funds at the designated time and though we want to pro-
25 tect the creditors with respect to the general assets of the

1 estate, it has been the view of all the courts that have con-
2 sidered this that because of the fact that the Referee, the
3 debtor in possession is himself an officer of the Bankruptcy
4 Court and because the debtor in possession is the person who,
5 by his negligence, failed to segregate these funds and failed
6 to set up the trust for the benefit of the Government, that we
7 ought not to make the beneficiary of the trust suffer because
8 of the negligence of an officer of the bankruptcy court. We
9 ought to give that beneficiary the right to rely on the fact
10 that an officer of the bankruptcy court is going to do what the
11 bankruptcy court tells him to, particularly when the bankruptcy
12 court states in the order that it shall supervise all these
13 operations on a weekly and monthly basis.

14 So that all who have considered this question have
15 felt that the equitable considerations which militate in favor
16 of recognizing this right to rely on the bankruptcy court
17 doing what it says it's going to do, should eliminate the re-
18 quirement of tracing the res of trust.

19 But, what I want also to make clear is that this
20 is not the ground -- this issue which I consider to be the
21 crucial issue in this case is not the issue that the courts
22 below went upon. The courts below, in my opinion, fundamen-
23 tally misconstrued the whole nature of withheld taxes and the
24 interrelation of the Bankruptcy Act with this trust fund.

25 Q I want to test your argument with a

1 hypothetical case if I may.

2 Suppose the money had been, indeed, put in this
3 segregated account and had built up to many thousands of dollars
4 over a period of time and a weekly check had been made and the
5 money was always there; then the officer of the company having
6 control of the account suddenly withdrew it all -- of the
7 segregated account, the tax, the trust account that you are
8 arguing about. He withdrew all of it out, got it in currency
9 and flew to Argentina.

10 Then would you say that you could impress any
11 constructive trust on the other assets of the company?

12 A That is a very different case than the
13 one we are facing, Mr. Chief Justice.

14 Q Oh, yes; oh, yes.

15 A And I think -- I'm not sure what the
16 answer to that question is; perhaps not, but I don't think
17 that controls this instant case, for the following reason --

18 Q No, but what I'm driving at is I'm trying
19 to set up the hypothesis where you could identify --

20 A If you can identify --

21 Q You can trace it all the way to Argentina
22 now?

23 A If you can identify the res of this trust
24 I, at the moment, can find no argument against the proposition
25 that the general assets of the creditors of this company ought

1 then to be subject to the Government's tax claim. I would not
2 want to go on record as committing the Government to that
3 position, but it seems to me that if you can trace the res of
4 the trust then you -- then the Government ought to be required
5 to go after that trace of the res and the persons clearly
6 responsible for the waste of the res of that trust.

7 Q Mr. Stone, I gather the employees get
8 credit for the amount on the books indicated as withheld from
9 their --

10 A That's right, Mr. Justice Brennan. Their
11 liability with respect to those withheld funds is charged at
12 the time wages are paid and taxes withheld from those wages.

13 Q Without payment ever by the employer --

14 A That's right. And similarly, if there are
15 any refunds are owed it is the employee who has the --

16 Q Well, the point is there is nothing in the
17 way of a trust involved here for the employees?

18 A No; it's a trust to the Government.

19 Q Only for Uncle Sam?

20 A Only for the Government. Now, that trust
21 is set forth in Section 7501 of the Internal Revenue Code,
22 which is quoted in page 26 of our brief and to which I refer
23 the Court, and that provision states as follows:

24 "Whenever any person is required to collect or
25 withhold any internal revenue tax from any other person and to

1 pay over such tax to the United States, the amount of tax so
2 collected or withheld shall be held to be a special fund in
3 trust for the United States."

4 Now, I take it that neither Respondent nor the
5 courts below would dispute that by virtue of Section 7501 an
6 employer who withholds income and social security taxes from
7 his employees' salary is the trustee of a trust, at least up
8 until the point that the employer becomes insolvent.

9 Now, let us consider the case of the employer's
10 insolvency and look briefly at Section 64 of the Bankruptcy
11 Act, which is set forth in relevant part at page 23 of our
12 brief. That section, entitled: Debts which have priority,
13 establishes those debts of the bankrupt which have priority
14 over general unsecured creditors of the bankruptcy proceeding.
15 And that section reads as follows:

16 "The debts to have priority in advance of the
17 payment of dividends to creditors and to be paid in full out
18 of bankrupt estates and the order of payment shall be (1) the
19 cost and expenses of administration, including the actual and
20 necessary costs and expenses of preserving the estate subsequent
21 to filing a petition." And then follows a general enumeration
22 of expenses considered to be administrative expenses of the
23 bankrupt estate, followed by four other categories of debts
24 which have priority.

25 And I note in that regard, just for the sake of

1 clarity that the fourth category of debts with priority in-
2 cludes "taxes which became legally due and owing by the bank-
3 rupt to the United States or to any state or any subdivision
4 thereof." And this priority for tax debts includes essentially
5 tax debts which are incurred by the employer prior to the in-
6 stitution of bankruptcy proceedings and it is not disputed that
7 tax debts incurred by the bankrupt during the bankruptcy pro-
8 ceeding are administrative expenses of the bankrupt estate and
9 share in the first priority. But that would not, in our view,
10 include these taxes for the reason I'm about to state.

11 Q Mr. Stone, we're really in a situation
12 here of tension between two statutes; aren't we?

13 A My precise point, Mr. Justice Blackmun is
14 that we are not in a state of tension between these two
15 statutes for the reason that though the Court of Appeals cer-
16 tainly thought we were, for the reason that Section 64 of the
17 Bankruptcy Act has nothing to do with trust funds. It deals
18 with administrative expenses of the bankrupt estate and unless
19 you can at some point identify withheld taxes as a tax debt of
20 the employer there is no tension because Section 64 has no
21 bearing on those --

22 Q This has to be your position. I think you
23 have no alternative. The question I wanted to ask, however,
24 is there anything in the chronology of the two statutes which
25 of help here? Which is the older of the two?

1 A Section 64 of the Bankruptcy Act is the
2 older of the two.

3 Q So that the other one which, as I recall,
4 came in about 1934, the newer one --

5 A Right.

6 Q -- does this lend you any support at all?

7 A Well, it lends -- I think it does lend us
8 some support. Of course it lends us some support that the
9 trust is still Congressionally enacted even though Section 64
10 was already on the books and the trust provisions of 7501 was
11 not refer in any way to a limitation arising from bankruptcy.

12 Q Do you know what prompted its birth in the
13 Revenue Act of 1934?

14 A The institution of the trust fund pro-
15 vision?

16 Q Yes.

17 A Yes. As far as we can tell the Senate
18 Report and the HouseReport are both rather limited in terms of
19 explaining the purpose, but as far as we can tell the trust
20 imposed in Section 7501 was designed to forestall the possi-
21 bility that courts would limit the Government to mere debt
22 collection procedures and would not allow either trust collec-
23 tion or tax collection extraordinary procedures against those
24 withheld funds.

25 Q Am I correct: did this statute come into

1 being before withholding was established?

2 A Withholding of income tax is after it;
3 yes. It came in before the withholding of income tax and
4 before the withholding of FICA, but there was already on the
5 boards withholding of various excise taxes and it was these
6 particular taxes which the original predecessor of Section 7501
7 was designed to take care of.

8 Q Well, in your view, isn't the trust
9 section imperative to the integrity of the Social Security Act
10 structure?

11 A It is imperative to the structure of the
12 Social Security Act and to the withholding of income taxes;
13 yes, it is, Mr. Chief Justice.

14 Our view is that the entire legislative scheme
15 which we discussed at length at pages 7 to 10 of our brief,
16 the entire legislative scheme behind the withholding of all
17 taxes shows that the Government serves merely as a collection
18 agent with respect to these taxes, that these are tax debts of
19 the employee to the Government and not of the employer to the
20 Government. And therefore, that these are neither taxes nor
21 debts of the bankrupt to the Government, and therefore
22 don't come under the provisions of the Bankruptcy Act which
23 establish priorities for debts and expenses of the bankrupt
24 estate.

25 Essentially, if an employee is paid \$100 in wages

1 receives \$85 and he is considered to have discharged the \$15
2 tax liability and the employer at that point merely holds, as
3 the Tenth Circuit recently said, holds as a collection agent
4 for the Government. He holds it for a brief period of time
5 and is required to pay it over.

6 And it's my submission to this Court that regard-
7 less of how strong a policy Section 64 of the Bankruptcy Act
8 embodies as to the administrative priorities of administrative
9 expenses, there is nothing in that provision which converts
10 trust funds into administrative expenses or which deals in any
11 way with the bankrupt's obligation to hand over funds which it
12 has received in the capacity of collection agent and neither of
13 the courts below nor the Respondent Trustee have attempted to
14 answer what I consider to be a crucial threshold question of
15 interplay at all does Section 64 have on these funds.

16 Q Do you think the Nicholas case bears on
17 our problem here?

18 A Yes. I think that it certainly needs to
19 be discussed. Of course, this Court reserved in Nicholas the
20 question before us here. Nicholas involved the question of
21 whether interest on withheld taxes accrued past the period of
22 bankruptcy or whether it stops with the institution of bank-
23 ruptcy proceedings or actual institution of bankruptcy.

24 And the Court in Nicholas held that interest did
25 not accrue. It held on the broad general principle that

1 interest during the bankruptcy proceeding ought not to accrue
2 at all because it eats away at creditors' assets and creditors
3 ought not be disadvantaged merely because of delays attribu-
4 table to the long length of the bankruptcy proceeding.

5 Q Does the Government have a lien for these
6 taxes?

7 A A lien? Not especially, Mr. Justice White.
8 It is not filed --

9 Q The Government doesn't have the same lien
10 for these withheld taxes as it would for the income taxes which
11 the employer himself owed?

12 A That is a question that, if it hasn't been
13 tested -- it can go in -- I suppose this hasn't been tested,
14 but I suppose it could go in under --

15 Q Suppose the Government has a protective
16 lien for income taxes and the employer goes bankrupt? What's
17 the relevant position of the Government, vis-a-vis for its
18 taxes and when it's got a lien for income taxes how do they
19 stand as against administrative expenses?

20 A I don't know the answer to that question,
21 Mr. Justice White, except that I believe that if the lien is
22 perfected that they stand ahead of all unsecured obligations,
23 including administrative expenses, but I'm not sure about the
24 answer to that.

25 I want to point out that the Court in the Nicholas

1 case, cited the second sentence of Section 7501, and I think
2 it is important, since no doubt the Nicholas case does have to
3 be examined to determine the outcome of this case. The second
4 sentence of Section 7501 after the trust is declared, says as
5 follows:

6 "The withheld taxes shall be assessed, collected
7 and paid in the same manner and subject to the same provisions
8 and limitations, including penalties, are applicable with
9 respect to the taxes from which such funds arose."

10 Now, we think, as we discussed in our brief, that
11 the legislative history of that statute makes it clear that it
12 was designed really -- though it says "limitations," it was not
13 designed to limit remedies but to expand Government remedies.
14 But, even with -- even the quoted language taken at its face
15 value is, I think, if anything, favorable to our position in
16 this case, because the phrase "taxes from which such funds
17 arose" clearly refers to the income and social security taxes
18 owed by the employees and withheld by the employer and these
19 taxes on the employees would not be subject to any collection
20 limitations by virtue of the employer's bankruptcy.

21 Now, they would be subject, in any bankruptcy
22 proceeding to a limitation on the accrual of interest during
23 the bankruptcy proceeding. But they would not be subject to a
24 limitation by virtue of the employer's bankruptcy and therein
25 I think lies the essential distinction, even given the fact

1 that the Court relied on the second sentence of Section 7501
2 in the Nicholas case. That is the essential distinction be-
3 tween Nicholas and this case.

4 Q Mr. Stone, in general an employer -- not a
5 bankrupt -- an employer doesn't have to, or does he, keep
6 withheld taxes in a separate fund? He may use them, can't he
7 in business ordinarily?

XXXX?? 8 A That is also an uncharted scene, Mr.
9 Justice Brennan. I think that --

10 Q Well, if he absconds with it is he prosecu-
11 ted as an embezzler?

12 A He could be.

13 Q Oh, really? Under Federal Law?

14 A I would think he could be. It is an em-
15 bezzlement because he is --

16 Q Well, is he prosecuted as an embezzler?

17 A I don't know of any cases that have
18 raised this --

19 Q Well, what do they prosecute him under?
20 This must happen, doesn't it, that an employer absconds with
21 the --

22 A Mr. Justice Brennan, I would have to say
23 that the Government has not tested at all the whole range of
24 permissible activity that an employer can conduct with respect
25 to these withheld funds. They are due so quickly -- in the

1 ordinary case they are paid over so quickly because they are
2 due --

3 Q If they are not and there has to be a
4 prosecution because he absconds with them, under what do you
5 prosecute? Some special provision of the income tax law?

6 A I don't know of a special provision that
7 would cover that.

8 Q So then it would have to be as an em-
9 bezzler?

10 A I would think that the embezzling remedy
11 would be available but I suppose -- I suppose a willful, a
12 criminal prosecution for willful avoidance of tax payments
13 under the normal criminal provision of the Revenue Code.

14 For these reasons I believe first, that this
15 Court ought to definitely make it clear that these withheld
16 funds are not expenses and debts of the employer to the Govern-
17 ment, but are held in trust by the Government, and that the
18 mere fact of bankruptcy does not defeat the trust set forth in
19 Section 7501.

20 And that in addition, the trust in this case ought
21 to be recognized even though the res is not specifically
22 traceable for the reasons set forth in our brief and as I have
23 elaborated on.

24 I would like to save whatever remaining time I
25 have for rebuttal.

1 MR. CHIEF JUSTICE BURGER: In order to avoid
2 interrupting you, Mr. Gillogy, let me put a hypothetical
3 question to you that may help me clear this up in my mind.

4 ORAL ARGUMENT BY KEVIN J. GILLOGY, ESQ.

5 ON BEHALF OF RESPONDENT

6 MR. GILLOGY: Yes, sir.

7 MR. CHIEF JUSTICE BURGER: Suppose -- I would
8 assume that a large employer like General Motors or others of
9 that category probably have, at any given day, millions of
10 dollars in the segregated accounts.

11 Now, hypothetically, assume the impossible, which
12 is that Congress, acting very swiftly, would simply abolish
13 the whole statutory scheme. Whose property would that account
14 -- the fund -- who would be the owners of that fund?

15 A I would say under the existing law it would
16 be the United States Government.

17 Q And would they be the legal owner only or
18 the equitable owner?

19 A Well, I would say the legal owner under
20 the trust theory. The legal title, of course, is in the holder
21 of the funds and the equitable title would be the United
22 States Government.

23 Q Well, don't you think the equitable title
24 would vest in the employees if the Act had been repealed? The
25 employees who had made these contributions under the Act --

1 A Oh, after the Act had been repealed --

2 Q That's right; the Act has been repealed.

3 A I'm sorry. If the Act had been repealed,
4 I think then the equitable title would be in the employees.

5 Q The employees. In other words, there would
6 have to be an accounting procedure to unscramble this very large
7 omelet and give to each employee what had, according to the
8 records of the employer, contributed to that fund.

9 A Yes, sir.

10 Q That would be unpaid wages, then; wouldn't
11 it?

12 A If the --

13 Q Subject to the limitations under the
14 -- with regard to priority that unpaid wages have under that
15 bankruptcy act. They certainly don't take over administrative
16 expenses.

17 A Are we now talking about a bankruptcy
18 proceedings? I understood Mr. Chief Justice was talking about
19 in any given situation exclusive of bankruptcy.

20 Q I was taking it one step at a time. I had
21 just taken the first stage and then you can pursue it with Mr.
22 Justice White's illustration and see where you would come out.
23 And see whether that has any bearing on this case.

24 A I -- well, I would say that once the case is
25 in the Bankruptcy Court, either by a Chapter proceedings or by

1 adjudication, then the entire Bankruptcy Act prevails. Then
2 the systems of priorities are set forth by Section 64. If this
3 were rescinded or if it were repealed or if the Courts were to
4 strike it down and there were no bankruptcy, then I think there
5 would be no question as to where it would go: the equitable
6 title would be in the employees.

7 Q Let me pursue the hypothetical a little bit
8 beyond that. Take a trust company, bank that has a large
9 trust department and the bank becomes insolvent and goes
10 through these processes. Are the accounts of the Trust Depart-
11 ment, or the Trust company segregated accounts? Do they ever
12 find their way into a bankruptcy proceeding of the corporate
13 trustee?

14 A I think by the nature of the Bankruptcy
15 Act I believe that the trust company is specifically exempted
16 under --

17 Q This is all hypothetical.

18 A Hypothetical, assuming --

19 Q All hypothetical.

20 A So I understand you fully, the trust
21 company became insolvent or bankrupt?

22 Q Right.

23 A I don't think there is any question at all
24 that the Bankruptcy Act would prevail, assuming that it did
25 come under the Bankruptcy Act, either voluntarily or

1 involuntarily.

2 Q You mean the general creditors could
3 reach into the segregated accounts of the beneficiaries of the
4 trusts? You don't mean that?

5 A I would say insofar as I understand trust
6 companies they hold some of them in trust pools, where they
7 comingle funds --

8 Q Yes.

9 A I think you get a different problem there.

10 Q This is not a trust pool --

11 A Was it an individual? Well, then again I
12 think you have an entirely different situation.

13 Q Well, the equitable owner in the trust
14 company hypothetical is the beneficiary of the trust; isn't he?

15 A Yes, sir; that's correct.

16 Q Well, I have taken you off enough --

17 A Yes.

18 Q Off the track.

19 A The Government seems to be relying rather
20 heavily upon the trust fund theory and of the theory of trusts
21 and trusts ex malificio... and I question why the Seventh
22 Circuit Court did not address itself to this. And I think it's
23 very obvious that the reason why the Seventh Circuit Court did
24 not address itself to this particular argument to the Govern-
25 ment is that it wasn't necessary for it to do so, because the

1 court there interpreted Section 64a to the Connecticut General
2 case did and the same as the Green case did: that number one,
3 they were not in conflict with one another; that Section 7501A
4 and 64a(1) could be read separately and by the second sentence
5 of 7501A it provided that the trust would have the same limita-
6 tions on it as the taxes from which the fund arose and then
7 went on to say that the taxes arose from and by virtue of the
8 Bankruptcy Act and therefore the Bankruptcy Act would prevail
9 and ergo Section 64a.

10 But, further, if this were not the case, that the
11 strong policy of 64a of the Bankruptcy Act would prevail over
12 the general provisions and the general policy of Section 7501.

13 I would like to review rather briefly the history
14 of these cases and starting out with the Guarantee Title Company
15 case, an opinion in 1912 where Section 3466 of the Internal
16 Revenue Code provided for a priority, as opposed to 7501 which
17 provides for a trust fund.

18 There the Supreme Court held that it was a bene-
19 ficient policy that 64a should prevail, especially and in that
20 case it pertained to wage earners. This was reaffirmed by this
21 Court in Davis versus Pringle in 1925.

22 Now, this line of cases goes undisturbed up until
23 the time of U. S. versus Nicholas or Nicholas versus U. S. which
24 was decided in this Court in 1964. The problem arises with the
25 line of cases under City of New York versus Rassner. And in the

1 Rassner case the first case in 1942 in which this trust fund
2 was found to apply. The Rassner case provided -- the Rassner
3 case said that it was a general provision of the Bankruptcy
4 Act in Section 64a, as opposed to the specific provisions of
5 the trust and the Rassner case went on to say that if it could
6 be shown that the policy or if the provisions of 64a were other
7 than general then the result would be different.

8 And this Court has shown in Nicholas versus the
9 United States, in express language said that it is a strong
10 policy that prevails in 64a. That being the case, then the
11 props fall from underneath the Rassner case and all of the cases
12 that follow it fall like dominoes.

13 This is the theory of the trustee. This has been
14 the position of the Trustee from the very inception of this
15 case.

16 In the Nicholas case the Court went so far as to
17 say that the taxes that were incurred during Chapter 11, and
18 this is precisely what we are talking about here, "come within
19 the first priorities of Section 64 of the Bankruptcy Act."
20 That is the costs of administration.

21 The history of the administrative and cost of
22 administration provisions of the Bankruptcy Act have constantly
23 worked towards allowance of cost of administration and away
24 from tax collecting. When you trace the history in the Bank-
25 ruptcy Act as enacted in 1800 and 1841, 1867 and 1898, all gave

1 top priority to taxes. It wasn't until 1926 that the priorities
2 were change, the cost of administration was advanced and the
3 taxes were reduced to a sixth priority.

4 Then, under the Chandler Act of 1938, the system
5 of priorities was retained and further the tax collector was
6 further restricted by being required to file his claim within
7 the limitations set on all other claims. And again, in 1952
8 the act was again amended to give further priority to costs of
9 administration by providing that costs of administration in a
10 superceding bankruptcy takes priority over the costs of ad-
11 ministration in the superceded Chapter proceeding, further
12 strengthening the position of costs of administration.

13 And lastly, the 1966 the most recent amendment,
14 which changed the priorities further or limited further the
15 claims for taxes by holding that the taxes could only be
16 claimed for a three-year period prior to the filing of the
17 bankruptcy.

18 So, we see here historically this picture of the
19 reducing of the tax claims and advancing the costs of admini-
20 stration and I think as the court below, in the very
21 scholarly opinion by Mr. Justice Hastings, points out and
22 refers to the Congressional, rather the Senate Reports and the
23 House Conference Reports as it applied to the costs of ad-
24 ministration and the need to preserve these costs of administra-
25 tion because, let's take just what could happen very easily in

1 this case.

2 The Government is only seeking to impress the
3 trust on those taxes that were collected by the debtor in
4 possession, but if you were to read Section 7501 it says "any
5 person who collects taxes." That would also mean the bank-
6 rupt prior to filing.

7 Further, in following the Rassner line of cases
8 if you have every state and every municipality enacting trust
9 fund legislation there is nothing left to administer in these
10 cases. Or, worse still, you have a trustee who is going to
11 wait and see if anyone is going to assert his trust rights and
12 the estate is going to go unadministered during this period
13 of time.

14 And, as the House Reports and the House Conference
15 Reports and the Senate Report, I believe it was in the 82nd
16 Congress, emphasize the necessity to protect the trustee in
17 order to have orderly administration of the estate. If you
18 don't protect the trustee, if you don't give him the first
19 priority, then you are not going to have orderly administration
20 of estates.

21 Addressing the normal routine that's employed by
22 the Trustee: first of all, he seizes the property in order to
23 protect it. In so doing he immediately incurs liabilities.
24 He's got to post a bond as required by court; he's got to assume
25 rent liabilities for use and occupancy; he's got to employ

1 inventory clerks; he has got to employ a closer(?) by rule of
2 court. These are all obligations that he, himself, must take.

3 Q Could I ask you a question about ordinary
4 taxes that a bankrupt owes a government -- a bankrupt company
5 owes the Government.

6 Let's assume the Government has perfected a lien
7 on the prior to bankruptcy on the assets of the individual of
8 the company. What is the status of that lien in bankruptcy
9 with respect to administration expenses?

10 A If the lien has been perfected the same as
11 any lien under the Uniform Commercial Code -- if it has been
12 perfected it is a valid and subsisting lien and that property
13 is excluded from the bankrupt's estate. But, that's by
14 separate statute.

15 Q Well, so is this.

16 A Yes, sir.

17 Q So is this. It's excluded from the bank-
18 rupt estate and yet the trustee takes possession of it at the
19 outset --

20 A Usually does as an accommodation, sir.

21 Q Well, no; it's still the bankrupt's
22 property, just subject to the lien; that's all it is. It's just
23 a perfected lien; the Government hasn't taken possession of it.
24 Now, the Trustee takes possession of the property -- it's the
25 bankrupt's property; it's just subject to the lien.

1 Now, doesn't the lienholder have to share ad-
2 ministration expenses?

3 A No, sir.

4 Q Not even if there isn't any other funds?

5 A No, sir; there is no provision in the
6 Bankruptcy Act, Mr. Justice White. The -- usually an accommo-
7 dation is worked out but the --

8 Q Let me ask you the question I asked Mr.
9 Stone: is this -- in 7501 it says that these amounts owing for
10 withholding taxes shall be assessed, collected and paid in the
11 same manner and subjected to the same provisions of limitation.
12 as other -- as applicable with respect to taxes from which that
13 fund arose.

14 Now, does that mean that the Government, if it
15 wants a lien, if it wants some priority over other creditors,
16 if it wants the position of a lienholder, must it perfect this
17 lien and what else could that language mean? I mean, it may be
18 a trust fund but it says its collectible in the same manner as
19 other taxes.

20 A Well, you are speaking now of the second
21 sentence of 7501(a)? Well, I feel that the interpretation put
22 on that language in the Connecticut Motor Lines case, in the
23 Green case and also in this case in the courts below is that the
24 trust has limitations placed upon it by, as the taxes from which
25 the fund arose, and that is the Bankruptcy Act and therefore

1 the Bankruptcy Act is applied.

2 Now, I think from the hypothesis that you gave me
3 it pertains to something entirely different, Mr. Justice White.

4 Q Why --

5 A Because it was, again, a separate statutory
6 procedure.

7 Q Yes, but the Government didn't take the
8 normal steps to perfect its tax claim here in order to give it
9 priority over administration expenses. There is no claim that
10 the Government has perfected any lien in this case; is there?

11 A No; there is none, sir. They did not per-
12 fect a lien. Well, as a practical matter, Mr. Justice White,
13 if that were the case, the Trustee wouldn't take possession of
14 the property and there would be no estate to administer. He
15 would file a "no assets report," and that would be the end of
16 the case.

17 Q If that's all the assets.

18 A If that's all the assets there were;
19 certainly. And that happens in any number of cases, not only in
20 tax liens but in uniform commercial code liens. This is very
21 commonplace. But there you have it set forth with clarity in the
22 law and if they have protected their position then there is
23 nothing to administer --

24 Q Would you say that is a trustee is appointed
25 for a company that has been adjudicated and he finds that the

1 only sizable assets the company has is made up of withholding
2 taxes that haven't been paid over to the Government, he is --
3 he won't treat that as a "no asset" case?

4 A He would treat that, sir.

5 Q Why? Under your position?

6 A No, because if I understand you, Mr.
7 Justice White, you are talking about funds that have been
8 segregated, but they are in a withholding tax account.

9 Q I'll just say that you find some bank
10 accounts and you find that the total amount owed for withholding
11 taxes exceeds the money in the bank. And there hasn't been
12 any segregation or anything; the only assets are bank accounts,
13 but the obligation for withholding taxes exceeds the amount in
14 the bank.

15 Now, would you make that a "no asset" case or --

16 A No, I would not, because the Government has
17 not perfected its lien rights in that instance, and it becomes
18 the general funds of the estate.

19 Q Yes.

20 A Then you get back again to 7401 and 64a,
21 where do the priorities lie?

22 Q Well, let me --

23 A Yes, Mr. Justice Brennan.

24 Q You said they did not perfect the lien.
25 I understand where the Government has perfected the lien you say

1 that's treated exactly as you would any other lien case under
2 the Commercial Code --

3 A Yes, sir.

4 Q But suppose it has not perfected the lien
5 -- take Mr. Justice White's hypothetical, except that the
6 money in the bank is earmarked -- earmarked on the account
7 title, as withholding taxes belonging to the United States.
8 What then is the case?

9 A Your Honor, I think you have a different
10 situation. As a matter of fact --

11 Q Would you think that is a "no asset" case?

12 A That's exactly what we did, sir in this
13 case. What we did -- let me change that: that's exactly the
14 way the Trustee treated funds that were on deposit in the bank
15 account that was created and set up in this case for deposit of
16 tax money. There was an account that was set up here and I
17 refer you to Abstract 39 which shows in the petition that
18 when the president of the corporation was questioned about the
19 assets he said that a bank account had been set up and this was
20 set forth in the petition. In Abstract 44, paragraph 1 of the
21 Referee's orders makes an order with reference to that bank
22 account.

23 Q Well, what we're dealing with here, I
24 gather, are taxes withheld after the petition had been filed?

25 A That is precisely what I am talking about.

1 Q And those taxes withheld had not been
2 deposited in that bank account, had they?

3 A I'm afraid I --

4 Q Had not been segregated in an account as
5 had the taxes withheld before the filing of the petition?

6 A They were filed during the Chapter 11
7 proceedings by the debtor in possession.

8 Q What did he do with them when he withheld
9 them?

10 A He deposited them in a special account in
11 the State Bank of Elk Grove Village in Elk Grove, Illinois.
12 Those monies may still be there for all I know. We exercised
13 no jurisdiction over them.

14 Q Well, what are we talking about?

15 A We're talking about separate funds that
16 were -- when the Government went into possession an order was
17 entered ording him to open up three accounts. He did open up
18 an account in the Elk Grove Bank for the purpose of withholding
19 taxes and FICA. He did make some deposits in them. He made
20 some deposits, but not enough. That's right. He hasn't touched
21 these funds.

22 Q So, to the extent that he created a separate
23 fund you make no claim --

24 A I make no claim.

25 Q But the Government makes a claim with

1 respect to the total he should have deposited?

2 A That's right and they want to impress a
3 trust on property, on capital assets of the corporation that
4 existed long before the Chapter 11 proceeding and is no way
5 traceable and there is no question of comingling. There is no
6 question of trust ex mal officio as it pertains to the cor-
7 porate funds.

8 Q In round numbers, taxes withheld by debtor
9 total how much?

10 A I would say roughly maybe \$200 or \$300.

11 Q And how much was deposited in the special
12 account?

13 A Oh, excuse me. The total amount that was
14 withheld, I'm sorry, was ten hundred and seventy-five dollars
15 and fifty-two cents. The amount that was deposited was maybe
16 two to three hundred dollars.

17 Q And so the seven hundred dollars he didn't
18 deposit, is that what we're fighting about here?

19 A No; the Government wants the entire sum.

20 Q Well, I know, but if he paid the \$200 or
21 \$300 on deposit there --

22 A Actually that would be it; it would be
23 whatever is in that account.

24 Q Who would you say had benefitted by the money
25 which should have lawfully been put into the segregated account

1 but which was not put in, according to both the statute and the
2 directions?

3 A I would say the wage earners, at least to
4 the extent that credit was given to them for the money that
5 should have been deposited. I can't see -- in no way at all
6 that the estate has been enhanced.

7 Q Doesn't the Government stand in the shoes
8 -- since the Government has had to take on the responsibility
9 of discharging the employees for that obligation, doesn't the
10 Government stand in the shoes of those employees? Shouldn't
11 they --

12 A As subrogees? I don't know any statutory
13 provision --

14 Q It's a matter of equitable, established
15 equitable principles relating to trusts.

16 A I would say under ordinary circumstances I
17 would have to buy your argument. However, I feel that what
18 we're here before this Court to interpret is the effect of
19 7501 and its interrelationship with 64a(1). And I'm just ask-
20 ing the Court to follow the precedents that have herebefore
21 been set: that it is a strong policy of 64a that must prevail
22 over 7501 if there is a conflict.

23 In other words, this 7501(a) applies up until the
24 moment any proceeding in bankruptcy is filed. Then the Bank-
25 ruptcy Act takes over completely. I don't think you can have

1 the bankruptcy apply just piecemeal and have collateral
2 legislation that is going to interfere with the administration
3 of the estate, which is what 7501 does; because you are in
4 real serious problems when it comes to the administration of
5 estates if you are going to ask a Trustee who is worth his
6 salt to come in and to expend money, his own money and incur
7 personal liabilities and not know whether or not there is a
8 trust that is going to be exerted by the United States Govern-
9 ment and I suggest later on if the Court is to reverse the
10 Courts below all the municipalities that would pass that legis-
11 lation and all the states that would pass that legislation,
12 you would have no orderly administration of the estate until
13 the Congress of the United States would untangle it and I
14 would say that there would be irreparable damage done to the
15 system, during the hiatus --

16 Q Excuse me.

17 A Yes, sir.

18 Q If the Government loses this case; if you
19 are right, it's claim is still an administration expense; isn't
20 it?

21 A Oh, no, sir; oh, no, sir; they are claiming
22 over and above --

23 Q What do you think -- what priority does the
24 Government's claim have?

25 A They enjoy a fourth priority under Section

1 64a(1). Excuse me -- no. Excuse me. No; I'm sorry. They
2 enjoy a first priority --

3 Q Administrative expenses --

4 A Administrative expense after the admini-
5 strative expense of the proceeding in bankruptcy --

6 Q Well, this is accruing during the operation
7 of the business --

8 A Yes, sir.

9 Q And so it's an administrative expense?

10 A Yes, sir.

11 Q And they don't, aren't postponed to their
12 usual position with respect to taxes?

13 A That's right; they do enjoy that first
14 priority, but subject to the one condition that I stated.

15 Q And that is only to about \$700 of it and
16 the two or three hundred dollars they can have 100 percent of
17 it?

18 A Yes, sir, but I think the principle is
19 much larger than that: what could be done to the entire system.

20 Q Yes.

21 MR. CHIEF JUSTICE BURGER: Mr. Stone, you have
22 four minutes remaining.

23 REBUTTAL ARGUMENT BY RICHARD B. STONE, OFFICE
24 OF THE SOLICITOR GENERAL

25 ON BEHALF OF PETITIONER

1 MR. STONE: Yes. I'll just take a minute, Mr.
2 Chief Justice. I want to clarify one point.

3 I have been informed by my co-counsel that, as
4 to the Government lien on these taxes, if it is on real
5 property it is -- comes ahead of administrative expenses; if
6 it's on personal property reduced to possession then it comes
7 ahead, but if it is on personal property not reduced to
8 possession it comes behind preferred expenses. However, a lien
9 in a Chapter 11 proceeding cannot be perfected against the
10 Trustee in any circumstances. The Government is --

11 Q It doesn't need it because --

12 A It doesn't need it because it has trust
13 fund anyway.

14 Q Or you can say it doesn't need it because
15 of its administrative expenses?

16 A That, I suppose, is an undesirable, but
17 albeit an alternative --

18 Q How about this bank account?

19 A Oh, Mr. Justice Brennan, there is some
20 reference -- there is a report filed after the institution of
21 -- the actual liquidation had occurred, which refers to a
22 special account in the bank, special tax account, but the
23 Referee specifically found, and I guess this is the facts for
24 the purposes of this case that no such monies had, in fact,
25 been entered. And it's unclear from the little record that we

1 have, about the \$200 or \$300, that it was in fact a special
2 Government account and I would say that for purposes of this
3 case we have to assume that we are going simply at the general
4 funds of the estate in imposing trust with respect to those
5 funds.

6 I want to say in conclusion only that I think that
7 Respondent's argument in this case merely affirms my prior
8 statement that neither the courts below nor the Respondents
9 have dealt with the issue of what is the nature of these debts:
10 are they tax debts of the employer owed to the Government or
11 does the employer hold them merely as collecting agent for
12 debts of the employee.

13 I don't see on the theory that either the court
14 below or Respondent has gone on, how they would recognize this
15 trust fund, even if the proper amounts had been segregated.
16 It seems to me that under their theory which precludes operation
17 under 7501 trusts when a bankruptcy proceeding starts, the
18 trustee would not have been authorized to pay over segregated
19 funds even if he had segregated them because they are simply
20 -- would be no trust in a time of bankruptcy and that is a
21 totally unacceptable holding, from our point of view.

22 Q What do you say about 7501 insofar as it
23 says taxes withheld by the employer shall be collected by the
24 same procedures as other taxes?

25 A We have dealt with that at length in our

1 brief, Mr. Justice White. Briefly to reiterate, we say first
2 of all that the legislative history shows that the real pur-
3 pose of that second sentence was to make sure that it would be
4 clear that tax remedies were available altogether to the
5 Government. There was a fear on the part of Government that,
6 absent that ordinary tax remedies would not be available
7 precisely because this was not a tax debt of the bankrupt and
8 the Congress wanted all available procedural remedies: trusts
9 and --

10 Q This was cumulative, not --

11 A Right; right. But even if it is viewed as
12 restrictive and I suppose it must be said that the Nicholas
13 Court and I believe the Court went perhaps farther than it had
14 to. As an alternative ground the Nicholas court invoked the
15 sentence to the proposition that interest couldn't be supported
16 during this time. To the extent that it is limiting I believe
17 that this case is distinguishable, because even though interest
18 would have been precluded on any tax debt, including the
19 employees' tax debt in a bankruptcy proceeding, the employees'
20 tax debts would have, at no time been subjected to the collec-
21 ting limitation of being placed in the bankrupt employer's
22 estate and his funds available for general creditors.

23 Thank you.

24 MR. CHIEF JUSTICE BURGER: Thank you, Mr. Stone.

25 Thank you, Mr. Gillogy.

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The case is submitted.

(Whereupon, at 2:50 o'clock p.m. the argument in
the above-entitled matter was concluded.)