

ORIGINAL

OFFICIAL TRANSCRIPT  
PROCEEDINGS BEFORE  
**THE SUPREME COURT**  
**OF THE**  
**UNITED STATES**

CAPTION: UNITED STATES, Petitioner v. THOMAS R. NOLAND,  
TRUSTEE FOR DEBTOR FIRST TRUCK LINES, INC.

CASE NO: 95-323

PLACE: Washington, D.C.

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IN THE SUPREME COURT OF THE UNITED STATES

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UNITED STATES, :

Petitioner :

v. : No. 95-323

THOMAS R. NOLAND, TRUSTEE FOR :

DEBTOR FIRST TRUCK LINES, INC.: :

Washington, D.C.

Monday, March 25, 1996

The above-entitled matter came on for oral argument before the Supreme Court of the United States at 10:01 a.m.

APPEARANCES :

KENT L. JONES, ESQ., Assistant to the Solicitor General,  
Department of Justice, Washington, D.C.; on behalf of  
the Petitioner.

RAYMOND J. PIKNA, JR., ESQ., Dayton, Ohio; on behalf of  
the Respondent.

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1 PROCEEDINGS

2 (10:01 a.m.)

3 CHIEF JUSTICE REHNQUIST: We'll hear argument  
4 first this morning in Number 95-323, United States v.  
5 Thomas R. Noland.

6 Mr. Jones.

7 ORAL ARGUMENT OF KENT L. JONES

8 ON BEHALF OF THE PETITIONER

9 MR. JONES: Mr. Chief Justice, and may it please  
10 the Court:

11 This case involves the detailed statutory  
12 priorities that Congress has enacted to govern the payment  
13 of claims in bankruptcy cases. Section 503(b)(1)(C) of  
14 the Bankruptcy Code provides that postpetition tax penalty  
15 claims are to be treated as administrative expenses of the  
16 debtor's estate with a first priority in payment.

17 The statute codifies this Court's 1966 decision  
18 in Nicholas v. United States, which reached precisely the  
19 same conclusion under prior law.

20 In this case, however, the court of appeals  
21 stated that it did not see the fairness or the justice of  
22 the first priority for postpetition tax penalty claims.  
23 The court stated that it would be more fair and more just  
24 for general commercial creditors to be paid in advance of  
25 tax petition claims and therefore reverse the statutory



1 priorities, changing the priority for postpetition tax  
2 penalty claims from first to last.

3 The court stated that its restructuring of the  
4 statutory priorities was justified by the principles of  
5 equitable subordination that Congress codified in 1978 as  
6 section 510(c) of the Bankruptcy Code, but the principles  
7 of equitable subordination do not confer such a broad  
8 power of statutory nullification on bankruptcy courts.

9 The principles of equitable subordination were  
10 designed to provide a remedy for the individual misconduct  
11 of a creditor in acquiring or pursuing his claim. As this  
12 Court stated in the Comstock case, the doctrine deprives  
13 the wrongdoer of the fruits of his wrong.

14 Prior to the enactment of the Bankruptcy Code,  
15 the courts have consistently held that in the absence of  
16 creditor misconduct, courts were not permitted under the  
17 principles of equitable subordination to simply disregard  
18 a statutory priority that they disagreed with. They were  
19 not permitted to say, as the court said in this case, that  
20 the statutory priority is a mistake and will not be  
21 enforced.

22 The court of appeals recognized in this case  
23 that under the traditional judge-made principles of  
24 equitable subordination, that doctrine served the limited  
25 function of providing a guarantee against creditor

1 misconduct, but the court reasoned that when Congress  
2 codified these principles in 1978, Congress somehow  
3 radically altered the scope of the doctrine, and that it  
4 is now appropriate for the court to disregard a statutory  
5 priority when the court concludes that it is just to do  
6 so.

7 QUESTION: Mr. Jones, do you agree that a tax  
8 penalty claim in theory could be subordinated if there  
9 were some sufficient reason for finding fault with the  
10 Government -- misconduct?

11 MR. JONES: I agree that the principles of  
12 equitable subordination can apply to all claims. Our  
13 understanding of those principles and the understanding  
14 that this Court stated in the Comstock case and that all  
15 other courts had stated prior to the enactment of the  
16 Bankruptcy Code was that what those principles did was to  
17 prevent a creditor from acquiring or pursuing a claim  
18 based upon misconduct. The legislative history of the  
19 Bankruptcy Code states, but we think it is obvious, that  
20 these principles of equitable subordination would rarely  
21 apply to a tax claim, but if --

22 QUESTION: Yes, but I took your position  
23 basically to be that in a particular case, no equitable  
24 subordination absent a showing of inequitable conduct.

25 MR. JONES: That is correct. That is what the

1 doctrine is designed --

2 QUESTION: And in theory the Government could  
3 engage in such conduct.

4 MR. JONES: In theory, it could. Again, I think  
5 it would be rare that we could think of a situation where  
6 that would happen, and the Senate report on this bill made  
7 that very point, but certainly, if the United States  
8 acquired a claim through misconduct, it would be subject  
9 to equitable subordination.

10 QUESTION: Of course, those of us who look to  
11 legislative history have got one problem from your  
12 standpoint, and that is, it may be that the person who  
13 made the statement about the intent was wrong in  
14 describing what courts had been doing, but the intent  
15 still seems to be there, and what is the tie-breaker? Do  
16 we look to the person's mistake, or to the person's intent  
17 in making the statement?

18 MR. JONES: Well, let me -- that is -- the court  
19 of appeals relied on what you're referring to, which is a  
20 fragment of a single sentence of the floor statements of  
21 the sponsors of the bill, but let's consider that  
22 statement in its context.

23 The sponsors made several points. First, they  
24 pointed out that the principles of equitable subordination  
25 that were being codified were those expressed in existing

1 case law, and certainly that represents an intent to  
2 incorporate, not to significantly alter the preexisting  
3 doctrine.

4 Second, the sponsors stated that under existing  
5 case law, the principles of equitable subordination served  
6 as a remedy for creditor misconduct much in the same way  
7 that this court had said in the Comstock case.

8 Now, the third thing they said, and this is the  
9 point that the court of appeals relied on, was that the  
10 principles of equitable subordination would also permit  
11 subordination of a claim of a status susceptible to  
12 subordination such as a penalty.

13 That statement was not a correct description of  
14 existing case law. There was literally no case law of  
15 that type prior to the adoption of the Bankruptcy Code  
16 and, indeed, as I have already mentioned, in 1966 in the  
17 Nicholas case this Court held that postpetition tax  
18 penalty claims were entitled to a first priority in  
19 bankruptcy.

20 The Senate report does not contain the  
21 misstatement that is in this fragment of the sentence from  
22 the floor statements.

23 QUESTION: But isn't there also a statement in  
24 that report that is not simply case law frozen as of a  
25 point in time but case law as further developed?



1 MR. JONES: We certainly agree that when  
2 Congress codified these principles it intended for the  
3 courts to continue developing them, and it is appropriate  
4 for the courts to continue devising rules that guard  
5 against creditor misconduct and that deprive the wrongdoer  
6 of the fruits of its wrong, but nothing in those ordinary,  
7 equitable principles provide any support for the novel  
8 contention that a court in equity can simply disregard a  
9 statute that it disagrees with.

10 As the Ninth Circuit said in the Stebbins case,  
11 neither general equitable principles nor the specific  
12 principles of equitable subordination authorize a court to  
13 simply say a statutory priority is a mistake and will not  
14 be enforced, and that is in essence exactly what the court  
15 of appeals held in this case.

16 QUESTION: The same statement, Mr. Jones,  
17 appears -- I mean, it was obviously carefully drawn up.  
18 It appears verbatim in both the House and the Senate, is  
19 that correct?

20 MR. JONES: That is my understanding, yes.

21 QUESTION: I mean, it's almost like a committee  
22 report. The floor leader in both chambers reads exactly  
23 the same text. Do you want to --

24 MR. JONES: And in both statements what they say  
25 is that this is what existing case law does. Our point

1 is --

2 QUESTION: That's a mistake, but --

3 MR. JONES: Yes.

4 QUESTION: -- insofar as it shows what the  
5 expectation or the intent of Congress is concerned, it  
6 seems to Congress expected and intended that a penalty  
7 would be subject to this doctrine. Congress is not in the  
8 business of figuring out what case law says. It is in the  
9 business of figuring out what disposition should be made.

10 MR. JONES: I think read in its entirety, which,  
11 of course, if we're going to read the legislative history  
12 we have to do that, read in its entirety, what the history  
13 manifests is an intent to incorporate existing case law  
14 and then a misdescription of one aspect of that case law.

15 The intent to incorporate existing case law is  
16 manifest in the Senate report which doesn't contain the  
17 misdescription of the existing case law, but beyond the  
18 question of intent and description is just the simple  
19 logic of the situation.

20 It is improbable that Congress intended, by  
21 adopting such a broad concept of equitable subordination,  
22 to have rendered all of its substantive statutory  
23 priorities essentially meaningless, which is a  
24 construction that would result from the opinion in this  
25 case, and let me see if I can explain that.

1                   QUESTION: Before you do, Mr. Jones, could you  
2 give us an example of the rare case in which a tax penalty  
3 claim could be subordinated, and you quoted the  
4 legislative history to that effect. You said that it  
5 would be a rare case --

6                   MR. JONES: Yes.

7                   QUESTION: -- and I was trying to envision such  
8 a case and couldn't come up with one.

9                   MR. JONES: Well, the situation that would exist  
10 with respect to private creditors is a situation where the  
11 claim was obtained by fraud or by ruse, or was obtained  
12 through some unfair manipulation of the bankruptcy  
13 process.

14                   It's hard for me, as it is for you, Justice  
15 Ginsburg, to put a concrete concept to apply those rules  
16 in a concrete way to tax collection.

17                   QUESTION: Well, what about a case in which some  
18 factotum of the Government said the payment, let's say to  
19 an ERISA plan or whatever it may be, is due in January,  
20 and in fact it was due in December and the Government is  
21 not estopped?

22                   I suppose you could say that's not a case of  
23 malicious wrongdoing, but it would be a case in which the  
24 taxpayer relied detrimentally on the Government and then  
25 ends up with perhaps a nonwaivable penalty. That would be

1 a case, I suppose, in which there could be subordination.

2 MR. JONES: I certainly believe that there are  
3 situations that could occur, and I'm obviously not here to  
4 try to anticipate all of them.

5 I will agree with you that if there was a  
6 situation where an authorized representative of the United  
7 States had taken some action that was unfair to other  
8 creditors in achieving a preference for a Government claim  
9 that wouldn't otherwise have been factually appropriate,  
10 that would be the kind of context in which equitable  
11 subordination might apply.

12 I think actually equitable subordination is a  
13 broad doctrine when it applies. It broadly is designed to  
14 prevent misconduct in any of its manners of manifestation,  
15 and we don't intend to suggest that it doesn't have this  
16 broad objective, but we think it reasonably clear it  
17 doesn't have the broad objective of making the statutory  
18 priorities essentially meaningless.

19 It is obvious, we think, that if the only  
20 effective priority rule in bankruptcy cases turned on a  
21 concept as elastic as fairness, that extraordinary  
22 uncertainty would exist for all creditors.

23 For example, on grounds of fairness should a  
24 tort claim for pain and suffering be subordinated on a  
25 rationale applied in this case that it's not a pecuniary



1     loss resulting from an extension of credit.

2                 What do we make of the fifth priority for claims  
3     based upon stored grain? Is that more fair than the new  
4     seventh priority for alimony and child support?

5                 Now, these kinds of categorical determinations  
6     are exactly what Congress does when it enacts these  
7     statutory priorities.

8                 With respect to tax penalty claims alone,  
9     Congress has four separate rules. Postpetition tax  
10    penalty claims are given a first priority, some types of  
11    prepetition tax penalty claims have a seventh priority,  
12    other types of prepetition tax penalty claims are treated  
13    as general unsecured claims in a Chapter 11 and are  
14    subordinated to general unsecured claims in a Chapter 7.

15                QUESTION: Mr. Jones, am I correct that every  
16    lower court that has confronted this issue has come out  
17    the way the court came out here?

18                MR. JONES: No -- well, there has been a recent  
19    set of cases that have said equitable subordination  
20    doesn't require proof of creditor misconduct. There has  
21    been a long, much more substantial history of cases that  
22    says that it do, and the cases -- that it does require  
23    creditor misconduct.

24                QUESTION: I mean, under this statutory  
25    provision, under the provision we're dealing with here, is

1     there any case that comes out the way you say this case  
2     should come out, denying the subordination on the grounds  
3     that the statute says otherwise? I thought --

4             MR. JONES: Since the enactment of the  
5     Bankruptcy Code, I believe that the courts of appeals that  
6     have addressed this issue have agreed with the proposition  
7     that we don't agree with, and that proposition is that  
8     this fragment in the Senate -- in the floor statement  
9     changed the law when Congress said they were intending  
10    to --

11            QUESTION: Well, of course, it isn't just the --  
12    the concurring opinion didn't rely on that in the court  
13    below, am I correct? She just relied on the plain  
14    language.

15            MR. JONES: Well, the concurring opinion I don't  
16    think ultimately reached the question that we're reaching  
17    here. The concurring opinion concluded that principles of  
18    equitable subordination can apply to --

19            QUESTION: And did apply in this case.

20            MR. JONES: And did apply, but I mean -- but --

21

22            QUESTION: So she didn't read that as requiring  
23    creditor misconduct.

24            MR. JONES: The point of the -- you and I might  
25    draw different understandings of the concurring opinion.

1 My understanding was that the concurring opinion was  
2 satisfied that equitable subordination applied.

3 QUESTION: Yes.

4 MR. JONES: And we --

5 QUESTION: She joined the judgment.

6 MR. JONES: She joined the judgment, and --

7 QUESTION: And she did not rely on legislative  
8 history. She relied just on the text of the statute.

9 MR. JONES: I didn't understand that she  
10 specifically discussed the question of how it applied.  
11 she was --

12 QUESTION: Well --

13 MR. JONES: -- addressing the question of  
14 whether it applied.

15 QUESTION: How did she get to join the judgment  
16 if she didn't -- you know, if she agreed with you?

17 MR. JONES: The court perceived -- no, she -- I  
18 didn't mean to say she agreed with us. I said, I don't  
19 think she specifically reached the question of how it  
20 applied.

21 The Government addressed two contentions in the  
22 courts below, at least as reading the majority opinion you  
23 would think they did. The two contentions that the  
24 majority opinion addressed were that equitable  
25 subordination simply cannot apply to a priority claim, and

1 I think -- and, of course, we don't take that position.  
2 We agree it can. It's just a question of how it applies,  
3 and my understanding of the concurring opinion was that  
4 she was addressing the question of can it apply and didn't  
5 specifically discuss how it applied. Now, that was my  
6 reading of it.

7 QUESTION: But she didn't have to discuss it,  
8 because she held that it did apply.

9 MR. JONES: Well, she certainly didn't disagree  
10 with anything that the panel --

11 QUESTION: No, but her basic point, as I read  
12 it, the reason she wrote was she didn't think it was  
13 necessary to look at legislative history because she  
14 thought the plain language of the statute covered the  
15 case.

16 MR. JONES: I think that --

17 QUESTION: That's why I thought she wrote  
18 separately.

19 MR. JONES: Justice Stevens, I don't mean to be  
20 arguing with you or quibbling with you, I just had a  
21 slightly different perception of what point she was  
22 addressing.

23 QUESTION: What is your position -- all right,  
24 everyone seems to agree that principles of equitable  
25 subordination apply. Next question, what are those



1 principles?

2 MR. JONES: That's correct.

3 QUESTION: What are those principles?

4 MR. JONES: Those principles --

5 QUESTION: Yes, all right. The first thing, you  
6 might take the position those principles are that, a) you  
7 never can equitably subordinate unless the holder of that  
8 particular piece of -- the creditor, that particular  
9 creditor has done something bad.

10 I take it that that is not your position. If it  
11 is your position, I take it that that is contrary to the  
12 case in which they said that some stockholders who were  
13 asserting a claim of fraud who did nothing wrong were  
14 equitably subordinated.

15 MR. JONES: I --

16 QUESTION: So is the -- is it your view that, no  
17 matter what, if you didn't do something bad and you're a  
18 creditor you cannot be equitably subordinated?

19 MR. JONES: That is a precise statement not only  
20 of our position but of this Court's position in the  
21 Comstock case.

22 QUESTION: All right. So you're saying that the  
23 5 to 4 decision in Comstock, which was basically a matter  
24 of the words used in that opinion, which were very  
25 eloquent, you think that those words overruled, sub

1     silentio, the earlier case in which shareholders who had  
2     asserted a claim of fraud against the corporation had  
3     their claim subordinated to others, I take it, because the  
4     judge felt this is simply a way in which shareholders that  
5     should be absolutely at the end of the queue have worked  
6     out to jump a lot of other people who would otherwise have  
7     been ahead of them, so they assert their claim in the form  
8     of a claim for fraud.

9             MR. JONES: Justice Breyer, I think that you  
10    have the timing and the courts wrong in your description  
11    of those two cases.

12            The Comstock case was a decision by this  
13    Court --

14            QUESTION: Yes.

15            MR. JONES: -- and it held that the doctrine is  
16    designed to deprive the wrongdoer of the fruits of his  
17    wrong, and that every case prior to the Bankruptcy Code  
18    held the same thing, except there was a Second Circuit  
19    decision that you were referring to involving the  
20    subordination of a shareholder's claim against the  
21    corporation.

22            Now, that Second Circuit decision in our view  
23    has both -- was a correct result, and contained some  
24    incorrect reasoning. It was a correct result because what  
25    the court concluded was that these shareholder claims were

1 brought as shareholders, and that a claim of a shareholder  
2 brought as a shareholder is subordinated by statute. It's  
3 subordinated by the long tradition of making shareholder  
4 interests at the bottom of the heap.

5 QUESTION: Brought as shareholder as opposed to  
6 brought as creditor?

7 MR. JONES: Yes, sir, brought in their capacity  
8 as a shareholder is a shareholder interest which is the  
9 last to be paid.

10 Now, there was some reasoning in that case  
11 which -- I'm trying to remember the name of it.

12 QUESTION: Let's assume you're right about it.

13 QUESTION: Credit Industrial?

14 MR. JONES: No, sir, I --

15 QUESTION: Well --

16 MR. JONES: Stirling Homex is the case we're  
17 talking about.

18 QUESTION: Yes.

19 MR. JONES: The reasoning in Stirling Homex --

20 QUESTION: Stirling Homex.

21 MR. JONES: -- that was manifestly incorrect is,  
22 you will notice toward the end of the court of appeals  
23 opinion in that case they relied on a bill that had been  
24 past the House. The bill that had been past the House  
25 said the claims could be subordinated on any equitable

1 grounds, a much broader concept than the principles of  
2 equitable subordination.

3 The Court in Stirling Homex said, this is good  
4 reasoning, this is the reasoning we're applying, but  
5 Congress, when it got around to passing the Bankruptcy  
6 Code rejected the House bill, adopted the Senate bill.

7 The Senate bill says that only principles of  
8 equitable subordination can be used to -- not just -- to  
9 justify subordination, and the Senate report in describing  
10 its bill accurately describes the existing case law that  
11 was being incorporated as cases that remedy creditor  
12 misconduct, so we believe that creditor misconduct is,  
13 indeed, what Congress --

14 QUESTION: It always -- let's assume it always  
15 has been. As I nonetheless read the words of the  
16 statutes, and so forth, isn't -- you reply to that by  
17 saying, yes, but the doctrine was a common law doctrine  
18 developed by judges, and there was no intent by Congress  
19 to freeze its contours. Just continue as you're  
20 continuing.

21 You find over the course of time, very slowly,  
22 that it needs to be shaped a little bit, that's what  
23 courts do. We don't want to change the law. We don't  
24 freeze it as it was at the time of, you know, Henry IV or  
25 whatever.



1 MR. JONES: Justice Breyer, we --

2 QUESTION: And so there could be a case -- I  
3 mean, there could be a case. That's the part that's --

4 MR. JONES: Justice Breyer, we agree completely  
5 that what the courts are disposed to continue to develop  
6 are the principles of equitable subordination, and we  
7 don't think that developing them would be to take a  
8 doctrine that all understand at the time of its  
9 incorporation into the code was based solely on creditor  
10 misconduct and specifically did not permit courts to  
11 disregard priorities it agreed with, and then, quote,  
12 develop this doctrine into a polar opposite, which is what  
13 we've ended up with in the court.

14 QUESTION: What the court here says is that the  
15 doctrine didn't develop into this area before the code,  
16 because before the code nonpecuniary loss tax penalties  
17 did not exist --

18 MR. JONES: Well, that's --

19 QUESTION: -- and that's how they explained --

20 MR. JONES: No --

21 QUESTION: -- the lack of any pre-code  
22 development.

23 MR. JONES: Justice Scalia, they said that  
24 pre -- well, I'll accept that terminology didn't exist,  
25 but actually what had happened were the decisions of this

1 Court, three decisions of this Court.

2 In, I believe, San -- San-something versus  
3 Granquist -- I'm sorry, I'm trying to remember a lot, and  
4 I'm not doing a good job. Simonson v. Granquist, the  
5 Court had said that the Bankruptcy Act did not allow  
6 penalty claims, and the Court in this case read that for  
7 everything it was worth, but it didn't really stand for  
8 that, because both before and after Simonson v. Granquist  
9 this Court had held in the Nicholas case, in the Boteler  
10 case that postpetition tax penalty claims were allowed and  
11 were entitled to first priority.

12 Now, that is our -- that is really the essence  
13 of our point here. The court of appeals misunderstood the  
14 history of tax penalty claims, it misunderstood the  
15 history of equitable subordination, and I am reminded,  
16 Justice Scalia, that I misspoke earlier when you asked me  
17 whether other courts had -- whether, after the Bankruptcy  
18 Code all courts had taken this perspective.

19 I am reminded of two situations where that  
20 didn't occur, the Mansfield Tire case, which really  
21 relates to the second case we're going to be arguing, the  
22 courts said that a penalty claim -- rather, that a  
23 statutory priority claim could not be subordinated on  
24 grounds of fairness, and also Judge Alito's concurring  
25 opinion in, I believe, the Burden case I think is a very

1 accurate description of what Congress was about in  
2 enacting the Bankruptcy Code and the fact that, to take  
3 the perspective that creditor misconduct is not what  
4 equitable subordination is about is really to say that all  
5 the other substantive priorities in the Bankruptcy Code  
6 don't have any meaning, that Congress did a meaningless  
7 act in writing the substantive provisions of the code.

8 If the only effective rule is fairness, then we  
9 don't have an effective rule. In our view, we --

10 QUESTION: The answer to Justice Scalia was that  
11 prepetition tax penalties were out of the queue --

12 MR. JONES: Were not allowed.

13 QUESTION: -- the absolute bottom.

14 MR. JONES: They weren't --

15 QUESTION: The postpetition tax penalties were  
16 Number 1.

17 MR. JONES: Number 1.

18 QUESTION: All right, so then that supports an  
19 argument that, sure, creditor misconduct is perhaps not  
20 always required. Suppose this were a prepetition tax  
21 penalty. But here, there's no good reason for the  
22 equitable subordination.

23 MR. JONES: Here, it's not --

24 QUESTION: Is that -- I mean, I'm making work  
25 because I'm interested in that aspect of it.

1 MR. JONES: As I will discuss in the next case  
2 to be argued, we think the principles of equitable  
3 subordination are the same in both contexts. We think --

4 QUESTION: Well, if they're the same, it's  
5 pretty weird that Congress, without even mentioning it or  
6 thinking about it, where there's a prepetition tax penalty  
7 would have decided without saying a word to jump them from  
8 the absolute bottom, behind shareholders, to absolute  
9 Number 1 --

10 MR. JONES: Oh --

11 QUESTION: -- without any mood -- room for  
12 flexibility, because that would be the effect of it,  
13 prepetition.

14 MR. JONES: They didn't jump prepetition tax  
15 penalty claims from bottom to Number 1. Number 1 is just  
16 postpetition tax penalty claims. Prepetition tax penalty  
17 claims were, as you say, jumped only to seventh priority  
18 or to general unsecured in 11, and in a 7, they're still  
19 subordinated.

20 Congress has gone to great pains to give us a  
21 very detailed, highly articulated set of statutory  
22 priorities. Congress did not undermine its -- all of its  
23 work by allowing courts to then say, well, let's just do  
24 what's fair.

25 We believe that principles of equitable



1 subordination that were incorporated into the Bankruptcy  
2 Code are designed as a remedy for creditor misconduct. It  
3 is unquestioned that the claim of the United States in  
4 this case is innocent, was not based on misconduct, and we  
5 believe that the court of appeals therefore erred in  
6 subordinating the claim that Congress gave the first  
7 priority to.

8 I'd like to reserve the balance of my time for  
9 rebuttal.

10 QUESTION: Very well, Mr. Jones.

11 Mr. Pikna, we'll hear from you.

12 ORAL ARGUMENT OF RAYMOND J. PIKNA, JR.

13 ON BEHALF OF THE RESPONDENTS

14 MR. PIKNA: Mr. Chief Justice, may it please the  
15 Court:

16 This is a Chapter 7 case. It is critical to  
17 remember that fact, because section 726 of the Bankruptcy  
18 Code, which controls the order of distribution in  
19 Chapter 7 cases, in order to assure the equality to all  
20 creditors begins with the clause, except as provided in  
21 section 510 of the Bankruptcy Code.

22 What the Government seeks to do is to  
23 effectively eliminate that section. It also seeks to  
24 eliminate the distinction between nonpecuniary loss tax  
25 penalties, which are the types of penalties which we have

1 in this case, from pecuniary loss tax penalty claims.

2 The difference is critical. In a prepetition  
3 context, for example, section 726(a)(4) of the Bankruptcy  
4 Code expressly subordinates nonpecuniary loss tax penalty  
5 claims to the claims of general unsecured creditors.

6 In this particular case, we have a plan that was  
7 confirmed. The vast majority of the penalties in issue  
8 arose very near the time of confirmation. There was no  
9 time for anybody to respond to determine -- for the  
10 creditors to react and say, gee, we ought to stop this.

11 When the case converted, the tax was owed, the  
12 penalties were owed, but these are not for financial loss.  
13 These are penalties that are punitive, or to deter, and as  
14 the Court stated unanimously in *Simonson v. Granquist*, the  
15 majority of the Court stated that the purpose of penalties  
16 is to punish, and the burden would fall on the innocent  
17 creditors in the case.

18 The dissent agreed with that proposition, that  
19 the punitive aspect of penalties was contrary to the  
20 intent of the Bankruptcy Code and the equality of  
21 distribution which was contemplated.

22 The Bankruptcy Code also distinguishes between  
23 nonpecuniary and pecuniary loss penalties in section  
24 507(a), now (8), formerly (7), which deals with the  
25 priority to be accorded to prepetition tax penalties.

1 In the context of section 503(b)(1)(C), where  
2 the Court -- where the statute refers to penalties, it  
3 does not draw that fine line distinction, because Congress  
4 did not have to.

5 By section 726, they expressly made 510  
6 applicable to those penalties and stated that they may be  
7 subordinated under section 510.

8 QUESTION: Mr. Pikna, the problem that I have in  
9 the case is a very broad conceptual one. That is, I can  
10 understand why Congress would say, there are cases which  
11 we cannot envision and cannot provide for by law because  
12 they turn on individual wrongdoing, or individual conduct  
13 in any event, and we want you, the courts, to provide for  
14 them. I can understand why Congress would do that.

15 What I cannot understand, and what would worry  
16 me very much, would be why Congress would say, we want  
17 you, in effect, to reorder the priorities that we have  
18 set, and to do so as a categorical matter because you  
19 think certain priorities are unworthy of the position that  
20 we have given them. That is statutory amendment.

21 I mean, that is delegation, to put it another  
22 way, without any standard at all. It is just saying, go  
23 out there and reshuffle the cards as you think right.  
24 That's the conceptual problem that bothers me.

25 What is your answer to the seeming impropriety,

1 perhaps even unconstitutionality of saying to a court, we  
2 have established priorities, but you go out and do  
3 anything you want to?

4 MR. PIKNA: Your Honor, this is not a  
5 categorical rewriting of the statute. This is merely  
6 looking at individual elements to be applied with the test  
7 of --

8 QUESTION: Yes, but the individual elements  
9 determine what goes into the category, and you are saying  
10 that certain category members should not be given the  
11 priority that their categories give them.

12 MR. PIKNA: Your Honor, we're merely saying that  
13 in order to evaluate equitable subordination, one of the  
14 elements which a test may consider is the nature of the  
15 claim. In this particular case, a nonpecuniary loss --

16 QUESTION: And Congress considered the nature of  
17 the claim when it established the categories, didn't it?

18 MR. PIKNA: It did, Your Honor.

19 QUESTION: I mean, this isn't something that  
20 Congress a) overlooked, or b) could not provide for.

21 MR. PIKNA: Your Honor, if we were to take the  
22 position that Congress, by establishing categories,  
23 determines definitively the priority to be accorded, then  
24 Congress has stated that general unsecured claims are to  
25 be paid in order of distribution under 726.



1           QUESTION: No, but one doesn't say that, and  
2           that's not what the Government is saying. The Government  
3           is saying that in fact a court may consider the kind of  
4           individual circumstances that bear on the conscience of  
5           equity that simply cannot be provided for in a categorical  
6           way in advance by a legislature, and that is all it has  
7           done, and once you get beyond that, you have basically  
8           gotten into statutory redrafting, or a claim of delegation  
9           not only without standards but standards quite contrary to  
10          those that Congress adopted, and that would seem to be an  
11          illegitimate interpretation of the statute.

12                 MR. PIKNA: Your Honor, if the court ruling were  
13          that all nonpecuniary loss tax penalty claims are  
14          automatically subordinated without more, we would agree  
15          that there is a new --

16                 QUESTION: Well, you're just saying we're only  
17          going to attack a portion of the category rather than the  
18          whole category, but it's still a category mistake, in  
19          effect, that you're claiming on Congress' part, and at  
20          least a partial categorical reordering that you're  
21          claiming for the court's authority under the statute.

22                 MR. PIKNA: Your Honor, it is a category, if the  
23          Court seeks to call it that, in the same sense that claims  
24          that were arising through misconduct are categories.

25                 QUESTION: But the distinction is that each

1 misconduct claim is judged on its merits as a particular  
2 misconduct claim, and it is the kind of claim that simply  
3 cannot be provided for any more precisely in advance.

4           These claims, indeed, could be provided for more  
5 precisely in advance, and if the courts of appeals have  
6 their way, there will be a constant, categorical  
7 reordering. There won't be any individualized inquiry in  
8 a particular case. You'll simply say, is this the kind of  
9 penalty, whoops, no priority for you, and it seems to me  
10 that those are fundamentally different enterprises --  
11 processes.

12           MR. PIKNA: Your Honor, the nonpecuniary loss  
13 tax penalties we agree are fundamentally different from  
14 pecuniary loss tax penalty claims, and we believe that in  
15 the context of administrative expense claims Congress  
16 chose not to expressly draw the distinction because the  
17 vast majority of cases that are filed are not just  
18 Chapter 11 cases. Chapter 11 cases comprise approximately  
19 1-1/2 to 2 percent of all the bankruptcy filings in the  
20 country.

21           QUESTION: No, but I think -- with respect, I  
22 think your answer doesn't go to my categorical problem.

23           Let me ask you this question. What if Congress  
24 had passed the Bankruptcy Act in its present form with one  
25 exception, and the exception is that in place of the

1 provision that we're fussing over this morning Congress  
2 had simply said, we've established these priorities, but  
3 the courts can, in fact, rearrange them if they want to,  
4 would that statute be in any kind of trouble?

5 MR. PIKNA: Your Honor, that would be a much  
6 broader statute which would permit the courts to --

7 QUESTION: We would be citing Schechter if that  
8 had been the case, wouldn't we?

9 MR. PIKNA: Your Honor, I don't recall which  
10 case specifically, but that would permit -- that would  
11 eliminate the statute at that point.

12 QUESTION: That's right, and it seems to me that  
13 to a degree, the degree being only the one category that  
14 you're arguing about, that is what you are arguing that  
15 the courts are able to do in this case.

16 MR. PIKNA: Your Honor --

17 QUESTION: It seems to me an example of what we  
18 both agree would have been improper.

19 MR. PIKNA: Your Honor, it is an example of one  
20 part of the test of the elements of equitable  
21 subordination that we believe it is appropriate for courts  
22 to consider, and the reason -- the courts have already  
23 recognized that penalties by their very nature are  
24 punitive. They are intended to punish or deter.

25 Here, the burden of the punishment falls not on

1 the wrongdoer, the debtor in this case, it falls on the  
2 creditors, because in order to -- what you are doing is,  
3 you're taking financial loss, you're taking funds from the  
4 parties that would normally share due to their financial  
5 loss.

6 QUESTION: Mr. Pikna, the first item under any  
7 tax, under 503, is any fine, so Congress was certainly  
8 thinking in terms of penalty, so we have fine, and then  
9 penalty, and you are not urging any -- in any case, where  
10 there was a fine or a penalty, on your theory wouldn't  
11 there be equitable subordination as long as the State  
12 didn't have enough to pay all the general creditors?

13 MR. PIKNA: No, Your Honor, we're not urging  
14 that position.

15 QUESTION: Well, give me a circumstance in which  
16 the estate does not have enough money to go around, that  
17 has been a nonpecuniary tax penalty. When would it not be  
18 subordinated on your theory?

19 MR. PIKNA: Your Honor, if, for instance, the  
20 postpetition claims in a case are \$1 million, all of the  
21 postpetition claims, and the nonpecuniary loss tax penalty  
22 claims are perhaps \$10,000, a very small portion, and if  
23 there is a small amount of funds to distribute, perhaps  
24 \$100,000 in the case, the impact of the nonpecuniary loss  
25 tax penalties relative to the other claims that are



1 recognized is de minimis, and that is the concept that was  
2 in part adopted by the majority in Nicholas v. United  
3 States. That was a very narrow 5-4 decision --

4 QUESTION: So if it's a small penalty it comes  
5 out in top and the Government gets it, but if it's a large  
6 penalty the Government doesn't?

7 MR. PIKNA: Your Honor --

8 QUESTION: The same thing with a fine, a small  
9 fine, the Government --

10 MR. PIKNA: Those are some of the factors, Your  
11 Honor. Those are not the exclusive factors.

12 QUESTION: Well, could one bankruptcy court  
13 decide a case like that one way, and another bankruptcy  
14 court decide the case the other way? I mean, is it a  
15 matter of just individual discretion on the part of the  
16 bankruptcy judge?

17 MR. PIKNA: Your Honor, equitable subordination  
18 by its nature requires that the court exercise its  
19 discretion, and if one court views the discretion to be  
20 applied in a different manner than another court, it's  
21 possible that the same fact pattern could result in two  
22 different outcomes.

23 QUESTION: So we'd have different outcomes all  
24 over the country, depending on the judgment of individual  
25 bankruptcy judges?

1 MR. PIKNA: It's possible, but it's unlikely,  
2 Your Honor, and we do not believe it is likely because we  
3 believe that the courts of appeal will establish standards  
4 as they have generally, and the courts of appeal are  
5 uniform in their position that nonpecuniary loss tax  
6 penalty claims do not require misconduct as a necessary  
7 element in order to reach the subordination question.

8 QUESTION: Do you have any other exceptions,  
9 other than de minimis, which I don't consider much of an  
10 exception. I mean, that's an exception to everything in  
11 the law.

12 MR. PIKNA: Your Honor --

13 QUESTION: De minimis non corat lex. It's not  
14 an exception at all.

15 MR. PIKNA: Your Honor --

16 QUESTION: That applies across the board. But  
17 except for that, every time there's a fine you want us to  
18 say it is subordinated.

19 MR. PIKNA: No, Your Honor.

20 QUESTION: It is the fineness that causes the  
21 subordination, isn't that right?

22 MR. PIKNA: Not totally, Your Honor. Your  
23 Honor --

24 QUESTION: What else?

25 MR. PIKNA: -- in a reorganization context, if

1 the company is in Chapter 11 and operating, there may not  
2 be a reason to subordinate penalties even though they are  
3 punitive by nature. The distinction here is that we are  
4 in a Chapter 7 case, and that we are in liquidating  
5 Chapter 7 case.

6 QUESTION: Mr. Pikna, do you say that because in  
7 the Chapter 11 the company may survive, may come out? But  
8 when I put the question to you I said, we have to make the  
9 assumption that there's not enough to go around. If  
10 there's enough to go around, it doesn't matter whether  
11 you're priority 1 or priority 10.

12 MR. PIKNA: Your Honor, if there's not enough to  
13 go around the creditors would have to vote for the plan.  
14 A company could still survive. It does not require, if  
15 there's not enough money to go around, that the company  
16 automatically liquidate, although that is likely to  
17 follow.

18 QUESTION: So what I don't understand on your  
19 theory is, in a case where we know there is not enough to  
20 go around --

21 MR. PIKNA: Your Honor --

22 QUESTION: -- like your Chapter 7 case, is there  
23 any situation in which a fine would not be subordinated, a  
24 fine or a penalty, nonpecuniary penalty would not be  
25 subordinated to the claims of the general creditors?

1 MR. PIKNA: Your Honor, an environmental fine  
2 may be an example of such a fine or penalty. A reason for  
3 that is that this -- as this Court exemplified through its  
4 ruling in the Mid-Atlantic case, the environmental claims  
5 are of a different nature, and they are very important to  
6 the policy to promote avoiding harm or damage to the  
7 environment.

8 QUESTION: Then the court just decides for  
9 itself what types of claims are very important and what  
10 are less important?

11 MR. PIKNA: Your Honor, it does that through  
12 reviewing other decisions of higher courts and through the  
13 policy expressed through the Congress through its  
14 enactments, through the statutes, and through the  
15 legislative history they can review.

16 QUESTION: What if Congress has made different  
17 findings -- you know, I think Congress probably thinks  
18 that most of its laws are pretty important and deserve  
19 priority, and the bankruptcy court just sorts it out  
20 depending on the recital at the beginning of the statute  
21 as to how important it is?

22 MR. PIKNA: Your Honor, the bankruptcy court has  
23 to consider all of the claims, not just the Federal  
24 claims. For instance, in this case there are also a  
25 number of State tax law claims, there are Workers



1 Compensation claims, there are highway use tax claims that  
2 are other Federal tax claims --

3 QUESTION: You can correct me, but I find it  
4 hard to imagine any policy that has traditionally been  
5 considered stronger than the policy of collecting taxes.  
6 I mean, we even allow property to be seized before the  
7 issue is resolved. I mean, is there anything that we've  
8 given higher priority to than the ability of Government to  
9 get the money in order to run?

10 MR. PIKNA: Your Honor, we believe that --

11 QUESTION: Do you think the environment's more  
12 important?

13 MR. PIKNA: Your Honor --

14 QUESTION: I'm no sure our cases would support  
15 that.

16 MR. PIKNA: Your Honor, I use --

17 QUESTION: For better or worse.

18 MR. PIKNA: I understand.

19 QUESTION: But that's what our cases seem to  
20 say.

21 QUESTION: Justice Scalia's opinion certainly  
22 wouldn't.

23 (Laughter.)

24 MR. PIKNA: Your Honor, we express that as an  
25 example. However, we do not believe that the tax penalty

1 claim for this type of tax, the trust fund taxes, these  
2 are the types of taxes that give rise to the responsible  
3 officer liability.

4 If the tax penalty claim is that important, then  
5 if the debtor does not pay it, that tax penalty should  
6 pass through and be transferred to the responsible  
7 officer. That is the party to be deterred.

8 QUESTION: Can you just answer two technical  
9 questions that I -- one was Justice Scalia's initial  
10 question, which the Government said -- is this correct, do  
11 you agree with the Government in this, and do I understand  
12 this correctly that, prior to the Bankruptcy Code a  
13 penalty on a postpetition tax did, in fact, receive a  
14 first priority?

15 MR. PIKNA: Yes, Your Honor.

16 QUESTION: All right. Thank you. The second  
17 question that I had is just as technical, and I want to  
18 know how it works.

19 Imagine that you are in Chapter 11, and we don't  
20 really have a lot of money, but we're trying to struggle  
21 to keep the company. I would imagine that the president  
22 of the company and the executives who are there running it  
23 ought to pay their taxes, and if they don't, I don't know  
24 why they shouldn't have to pay penalties the same as  
25 anybody else, and I don't know why that isn't an

1 administrative expense like anything else, postpetition.

2 But I did imagine from what you're saying that  
3 there could be a case where we're finding it hard to get  
4 unanimous agreement among unsecured creditors, and the  
5 bankruptcy judge works out that if I could subordinate the  
6 penalty on the tax below the unsecured creditors there  
7 will be enough money for them under a section 7, and  
8 therefore I don't need the unanimity, and that might be  
9 why he wants to subordinate in the Chapter 11. He wants  
10 the authority to have subordinated the penalty in the  
11 hypothetical Chapter 7.

12 Now, I raise that to know if that's technically  
13 right, or if it's not, just say no, and I will erase it  
14 from my mind.

15 MR. PIKNA: Your Honor, the subordination  
16 provisions are applicable in all chapters. The amount,  
17 the degree of subordination varies based on the facts of  
18 the case.

19 Now, in the context of a Chapter 7 case, we  
20 believe that the policy of equitable -- of equal  
21 distribution, excuse me, is critical, and the court looks  
22 to what is to be accomplished.

23 QUESTION: All I'm trying to do is to explore if  
24 there's any circumstance, other than de minimis, in which  
25 it would make sense, given all the equitable authority in

1 the world, to subordinate a postpetition tax penalty, and  
2 I'm struggling to think if there's any such circumstance,  
3 and so far, given your answers, I think the answer is no,  
4 there is no such circumstance that would be special.

5 So I'm trying to think, I'm struggling, is there  
6 any circumstance in which it would make sense, equitably,  
7 and your answer to that, which you have a strong interest  
8 in saying I'm wrong, all right, why am I wrong? That's  
9 what everybody's been asking you, I think.

10 MR. PIKNA: Your Honor, it will also vary on the  
11 nature of the debtor and who bears the penalty.

12 What we are expressing is that the penalties are  
13 subordinated not because they're just nonpecuniary loss,  
14 but in this particular context it is a corporate debtor,  
15 it is a debtor in Chapter 7, and there are insufficient  
16 funds to go around.

17 Now, the degree of subordination that the  
18 bankruptcy court stated subordinate to general unsecured  
19 claims, if that is error would be harmless error. The  
20 court could have said, just subordinate the nonpecuniary  
21 loss penalty to other administrative expense pecuniary  
22 loss claims, so there is a degree, a range of discretion  
23 that can be exercised by the bankruptcy court.

24 The creditor body may be comprised primarily of  
25 shareholders who made loans to the corporation and who are



1 also in control, and that might be another context where  
2 the court would feel that it is not appropriate to  
3 subordinate, but the court starts with the position that  
4 the claim has priority. It is up to the moving party to  
5 establish that it is entitled to subordination.

6 Perhaps the correct remedy here would have been  
7 for the Internal Revenue Service to have asked for the tax  
8 to be subordinated, because the responsible officers under  
9 section 6672 of the Internal Revenue Code are responsible  
10 for the tax and interest, but it does not state that  
11 they're responsible for the penalties.

12 So there's no deterrent effect on section 6672  
13 of the Internal Revenue Code, which is really what this  
14 particular case and these particular taxes are about, for  
15 the officers to not go ahead and not pay the taxes. What  
16 do they care? They don't have to pay it.

17 It's the creditors, the innocent creditors who  
18 are giving value to the debtor, who are trying to assist  
19 the corporation in reorganizing, who find out after the  
20 debtor fails to pay taxes that they are now also being hit  
21 with this large penalty, a penalty for which the Internal  
22 Revenue Service gave nothing, but which the statute says,  
23 debtor, if you do something wrong, you will be punished.

24 The taxpayer is the party to be punished, but in  
25 this particular case it is not the taxpayer that bears the

1     burden of that punishment, it is the innocent creditors,  
2     the same creditors which this Court recognized in Simonson  
3     v. Granquist, both the majority and dissenting opinions  
4     recognized.

5             QUESTION: But isn't that always the case? I  
6     mean, what you're arguing is, Congress should not have  
7     said in 503(b)(1)(C) any fine, penalty, or reduction in  
8     credit relating to a tax.

9             MR. PIKNA: No, Your Honor, because --

10            QUESTION: Isn't a fine relating to a nonpayment  
11     of tax, isn't it always going to come from the creditors?

12            MR. PIKNA: Your Honor, a fine may, but 503  
13     applies to not just liquidation cases, it applies to  
14     Chapter 9, Chapter 13, Chapter 11, Chapter 12, all cases  
15     in which the debtor operates.

16            In this particular context, we have a very  
17     narrow category of cases. We have a very small number of  
18     cases --

19            QUESTION: Those other cases, when you take the  
20     money away from the debtor you're effectively taking it  
21     away from the creditors. The debtor is still operating in  
22     a bankruptcy context, isn't he?

23            MR. PIKNA: That's true, Your Honor. The key  
24     word --

25            QUESTION: So --

1 MR. PIKNA: -- there is operating, and when it's  
2 operating, it should be punished for what it is doing  
3 wrong. It still exists. It is there to punish.

4 QUESTION: I see. You view it as being taken  
5 away from the creditors in the title VII context but not  
6 in other contexts. I'm not sure that's realistic.

7 MR. PIKNA: Your Honor, it's being taken away,  
8 we recognize that, but we believe that there is certainly  
9 a vital distinction in the liquidation context, and the --

10 QUESTION: You're saying --

11 QUESTION: But while the business is ongoing you  
12 wouldn't get to the Bankruptcy Code and it's priorities,  
13 so the only time you get to these priorities is if the  
14 thing is postpetition and you're in a bankruptcy and  
15 you're distributing and there's not enough to go around.

16 MR. PIKNA: That's not totally correct, Your  
17 Honor. In the bankruptcy context, when the company is  
18 operating, it will pay taxes on a regular basis, and  
19 section 503(b)(1) recognizes that the taxes --

20 QUESTION: Yes, but we're not concerned with  
21 priorities, are we, at that stage?

22 MR. PIKNA: Your Honor, we are in the sense that  
23 you can only pay during the operation costs and expenses  
24 incurred in the ordinary course of business, and that's  
25 what 503(b) states. It deals with administrative

1 expenses, and there are certain types that you can pay in  
2 the ordinary course, and other types that you have to ask  
3 the court for the authority to pay.

4 For instance, if you are going to be leasing  
5 property, you have to go to the court to expect to assume  
6 the lease if you intend to keep it, and then once it is  
7 assumed you can pay that rent in the ordinary course.

8 Part of the assumption process requires also  
9 that you bring current lease payments which normally would  
10 be a prepetition claim, which would be paid with general  
11 unsecured creditors. There's a different category of  
12 claim that there the Congress has said you have to bring  
13 these things current and place them together.

14 In this particular case, we have a liquidation  
15 context, which is something that Congress contemplated  
16 when it started off section 726 of the distributive  
17 provisions and stated, except as provided in 510. Yes,  
18 section 726 certainly recognizes the priority to be  
19 accorded to administrative expense claims generally.  
20 That's a given. The next thing, though, is that it also  
21 expressly provided that there may be situations under  
22 section 510 that it is appropriate to equitably  
23 subordinate.

24 The body of law that existed at the time the  
25 Bankruptcy Code was enacted focused on pecuniary loss



1 penalty claims. The trilogy of cases in this Court,  
2 Taylor v. Standard Gas and Electric Company, Pepper v.  
3 Litton, and the Comstock case, each dealt with pecuniary  
4 losses in the context of parties --

5 QUESTION: That wasn't the factor emphasized by  
6 the Court in those cases, was it? I thought it was  
7 misconduct on the part of the claimant.

8 MR. PIKNA: Your Honor, the factor that was  
9 emphasized by the Court was misconduct in a -- in terms of  
10 trying to promote its claim for financial loss ahead of  
11 other claims for financial loss, but from that there was a  
12 silence on nonpecuniary loss claims. That issue was not  
13 addressed in any of those cases, and that's why this Court  
14 at this time is writing on a blank slate.

15 QUESTION: Well, is there any suggestion in  
16 those cases that that sort of a distinction would have  
17 been made by those courts?

18 MR. PIKNA: Your Honor, we do not believe that  
19 particular concept was addressed, other than, in Pepper v.  
20 Litton the Court recognized the broad equitable powers of  
21 bankruptcy courts to adjust the debtor-creditor  
22 relationship, and that same policy has also been  
23 recognized by this Court in the energy resources case  
24 when, in dealing with the context of trust fund taxes,  
25 this Court recognized in an operating Chapter 11 case the

1 importance of permitting the designation of the  
2 responsible officer type of trust fund taxes to be paid  
3 ahead of the nonresponsible officer types of taxes and  
4 interest.

5 QUESTION: Mr. Pikna, it does appear that the  
6 Members of Congress had in mind the requirement of  
7 misconduct as a principle of equitable subordination,  
8 doesn't it?

9 MR. PIKNA: Your Honor, that is one of at least  
10 two or three things that Congress had in mind. The  
11 legislative history states very clearly that it intends  
12 the courts to continue to apply the principles of  
13 equitable subordination, which are first, misconduct, or  
14 claims of a status susceptible to subordination such as  
15 penalties.

16 The legislative history did not define  
17 penalties, but Congress was aware of certainly the  
18 Simonson case as well as any other case which it might  
19 refer to where this Court expressed the repugnance of  
20 penalties generally, not just nonpecuniary loss penalties,  
21 but all penalties, and how that adversely affected the  
22 policy of equality of distribution to creditors, a policy  
23 which is critical to the opportunity for courts to  
24 reorganize.

25 The requirement for misconduct in order to

1 subordinate is not in the Bankruptcy Code. To the  
2 contrary, in the context of prepetition, nonpecuniary loss  
3 tax penalty claims, those would normally be general  
4 unsecured claims under 507(a), now (8), of the Bankruptcy  
5 Code, and if those are to share equally, you could not get  
6 a confirmed Chapter 11 plan.

7 QUESTION: Well, misconduct comes in through the  
8 language of 510(c), where it says, principles of equitable  
9 subordination, doesn't it --

10 MR. PIKNA: Yes, Your Honor.

11 QUESTION: -- because it was those principles,  
12 the misconduct, that had been the dominant theme of those  
13 three cases that you referred to.

14 MR. PIKNA: Yes, Your Honor, that comes in, but  
15 that is not a limitation, that is an example. That is how  
16 the subordination principles began to evolve at that point  
17 in time.

18 QUESTION: Yes, but certainly in each of those  
19 three cases it seemed to me when I read them that the  
20 stress was on the conduct of a particular individual in  
21 pursuing the claim, not on any general transposition of  
22 the priorities that had been given by Congress.

23 MR. PIKNA: Your Honor, they were looking at the  
24 conduct, but those were the facts presented in that case.  
25 There was no prior case before this Court dealing with a

1 nonpecuniary loss until the Simonson case, where it was  
2 dealt with by the statute, where the statute stated that  
3 non -- prepetition nonpecuniary loss of tax penalty claims  
4 were disallowed. Not just subordinated, totally  
5 disallowed.

6 QUESTION: And the statute said that.

7 MR. PIKNA: Yes, Your Honor, it did.

8 QUESTION: Well, so that really isn't much of a  
9 precedent for your argument here. I mean, if the statute  
10 says something, that's pretty much the end of it.

11 MR. PIKNA: Your Honor, the statute said that,  
12 but the Court interpreted the statute, and in interpreting  
13 the statute stated that all penalties -- it did not just  
14 say these particular nonpecuniary loss tax penalties, and  
15 that is the critical theme.

16 It is the nonpecuniary loss nature, rather than  
17 the timing of the penalty, which is one of the elements to  
18 be considered. It may be the primary element, but it is  
19 not the sole element. And it is up to the bankruptcy  
20 courts, through the exercise of their discretion, with the  
21 guidance from this Court and other courts, to determine  
22 under what circumstances is it appropriate to subordinate.

23 Certainly, Congress could not contemplate all of the  
24 circumstances. When it drafted section 510 of the  
25 Bankruptcy Code it was intended to apply across the board



1 to all chapters, not just Chapter 7 cases. When it  
2 drafted section 510 of the Bankruptcy Code, it was  
3 intended to apply to all chapters, not just bankruptcy  
4 cases, and in this context we have a very narrow set of  
5 facts.

6 We have a Chapter 11 case, where a debtor was  
7 permitted to operate. The position of the Government is  
8 that the creditor should act as private Attorney General  
9 in order to prevent the nonpayment of taxes. We submit  
10 that's not realistic.

11 The creditors don't know that the taxes are not  
12 paid until the return is not filed, or is filed, and then  
13 the taxes are not paid and the penalty is not paid. By  
14 that point in time, the damage is done. The creditors  
15 cannot change what has already transpired. There may be a  
16 distinction, in fact, between a failure-to-file penalty  
17 and a failure-to-pay penalty.

18 QUESTION: Well, it won't help the creditors in  
19 that case, but future trustees will know that by not  
20 paying taxes they're not going to make more money  
21 available to the creditors. In fact, they'll make less.

22 MR. PIKNA: Your Honor --

23 QUESTION: Which is worthwhile.

24 MR. PIKNA: Your Honor, it is not the trustees,  
25 it is the officers of the corporation.

1 QUESTION: Thank you, Mr. Pikna. Your time has  
2 expired.

3 MR. PIKNA: Thank you, Your Honor.

4 QUESTION: Mr. Jones, you have 5 minutes  
5 remaining.

6 REBUTTAL ARGUMENT OF KENT L. JONES

7 ON BEHALF OF THE PETITIONER

8 QUESTION: Mr. Jones, could you tell me, how  
9 does it work if the officers are liable for the tax? Does  
10 the Government have a choice of whether it goes to the  
11 officers first or the corporation first?

12 MR. JONES: A choice in the sense that each are  
13 liable separately, but when either pays, it reduces the  
14 liability of the others. I mean, we can't collect -- they  
15 are separate liabilities under the code, but  
16 administratively they're set off against each other, but  
17 let me --

18 QUESTION: I take it if you went after the  
19 officer, he'd then be just a general unsecured creditor  
20 against the corporation.

21 MR. JONES: Congress has dealt with that  
22 specifically. I mean, you're assuming a situation where  
23 the employee -- where the officer is in bankruptcy, is  
24 that correct?

25 QUESTION: No. I'm assuming a situation where

1 the officer is solvent. The Government goes after him and  
2 gets the tax from him.

3 MR. JONES: Yes.

4 QUESTION: Does that officer then become a  
5 general unsecured creditor against the corporation for  
6 having paid the corporate --

7 MR. JONES: I frankly don't know whether the  
8 officer -- what the nature of the officer's claim against  
9 the corporation would be. It would be some kind of common  
10 law indemnity claim, I assume.

11 QUESTION: The argument was there's no incentive  
12 because the penalty isn't passed through.

13 MR. JONES: Well, the penalty that's been  
14 discussed, the responsible officer penalty, only applies  
15 in narrow -- in particular situations. It only applies  
16 where the officer is responsible for the withholding and  
17 paying over of a specific tax. It applies to trust fund  
18 taxes.

19 QUESTION: But I understood that the officer's  
20 not liable for the penalty, and counsel's point, counsel  
21 for the respondents, said, well, there's no incentive here  
22 because the officer is never liable for the penalty.

23 MR. JONES: Oh, for the tax penalty.

24 QUESTION: Yes.

25 MR. JONES: Well, certainly for the -- yes,

1 that's correct. For the late payment penalty?

2 QUESTION: Yes.

3 MR. JONES: For the late payment or the  
4 underpayment penalties --

5 QUESTION: Only the corporation is --

6 MR. JONES: Only the corporation would be liable  
7 for those penalties. The liability under 6672 is for a  
8 failure to turn over a tax that's been collected, and it's  
9 only trust fund taxes. It's not -- it doesn't generally  
10 apply to all different kinds of taxes.

11 QUESTION: So the point was that there was no  
12 inducement, or no incentive, because the officer's never  
13 going to be liable for the penalty anyway.

14 MR. JONES: Well, this Court addressed, of  
15 course, the question of whether this is a fair result in  
16 the Nicholas case, and the Court said that the first  
17 priority for postpetition tax penalties is necessary to  
18 ensure that the debtors abide by the same rules that all  
19 other people conducting business abide by.

20 The priority, if you will, is fair in this broad  
21 legislative sense, because it deprives the debtor of an  
22 unfair advantage vis-a-vis everybody else who's out there  
23 conducting business.

24 The contention that it's unfair to specific  
25 creditors in this bankruptcy case is just another way of



1 saying that they think the Congress made a mistake, that  
2 it's not a good idea to have this priority. We think that  
3 when Congress goes to the trouble of drafting these  
4 priorities, they do it for a reason. The reason is  
5 because they think this is a good idea in a general,  
6 abstract way. We don't think that there's anything in the  
7 Bankruptcy Code that permits courts to reassess those  
8 general fairness questions.

9 QUESTION: He's identified, I take it, not this  
10 case but a very unusual situation. You're in Chapter 11.  
11 The penalties amount -- postpetition tax penalties amount  
12 to \$10 million. If you must give them first priority in a  
13 section 7, you're not going to get agreement of the  
14 unsecured creditors on the 11 plan.

15 But if the bankruptcy judge could say, ha ha, in  
16 a 7 I could subordinate the \$10 million to you, unsecured  
17 creditors, then there would be enough under the 11 plan to  
18 give them what they would have gotten in section 7, and  
19 therefore the bankruptcy trustee can get approval without  
20 unanimity.

21 MR. JONES: I may --

22 QUESTION: Now, that's what I'd raised before  
23 because I got that somehow out of the briefs. Now, that's  
24 what I wanted --

25 MR. JONES: I heard you ask that question, and

1 even hearing you describe it again I'm not 100 percent  
2 sure I understand the question, but let me tell you what I  
3 think the answer is as I understand it. If you're in --

4 QUESTION: Well, maybe I don't -- yes.

5 MR. JONES: If you're in a Chapter 11 --

6 QUESTION: Yes.

7 MR. JONES: And the question is, can you get  
8 unanimity, and the answer is no, but is there some way to  
9 cram it down? 1129(a)(7) specifies that if you want to  
10 cram it down on the nonconsenting creditors you've got to  
11 give them the same treatment they'd get in a 7, and so in  
12 a 7, under 726(a)(1), the first priority of this  
13 postpetition tax penalty claim is recognized.

14 QUESTION: Right.

15 MR. JONES: In an 11, the court has to recognize  
16 it, too.

17 QUESTION: Right, and that's why what the  
18 bankruptcy trustee wants to say, well, were I in a 7, I'd  
19 take the \$10 million and put it at the end of the queue.

20 MR. JONES: No, but you can't do that.

21 QUESTION: I have that power, and therefore I  
22 don't have to count it against --

23 MR. JONES: You don't have that power in a 7,  
24 because in a 7 we're talking about postpetition tax  
25 penalties. Postpetition tax penalties in a 7 are a first

1 priority.

2 QUESTION: Unless they could be equitably  
3 subordinated --

4 MR. JONES: Well --

5 QUESTION: -- but that's -- see, what I'm trying  
6 to do is to find --

7 MR. JONES: If they could be equitably  
8 subordinated, I agree. If you could ignore a priority by  
9 subordinating it, you can always advance the interests of  
10 other creditors, and so if that's your question, I --

11 CHIEF JUSTICE REHNQUIST: Thank you, Mr. Jones.

12 MR. JONES: Thank you.

13 CHIEF JUSTICE REHNQUIST: The case is submitted.

14 (Whereupon, at 11:01 a.m., the case in the  
15 above-entitled matter was submitted.)  
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## CERTIFICATION

*Alderson Reporting Company, Inc., hereby certifies that the attached pages represents an accurate transcription of electronic sound recording of the oral argument before the Supreme Court of The United States in the Matter of:*

UNITED STATES, Petitioner v. THOMAS R. NOLAND, TRUSTEE FOR DEBTOR FIRST TRUCK LINES, INC.

CASE NO:      95-323

*and that these attached pages constitutes the original transcript of the proceedings for the records of the court.*

BY Don Mario Federico

(REPORTER)