

Consumer Track
Cutting-Edge Issues
in Agriculture Bankruptcies

Joseph Hawbaker
Hawbaker Law Office; Omaha, Neb.

Phillip L. Kunkel
Gray, Plant, Mooty, Mooty and Bennett, P.A.
St. Cloud, Minn.

Hon. Thomas L. Saladino
U.S. Bankruptcy Court (D. Ne.); Lincoln

Donald D. Sunderland
Mullin Hoard & Brown LLC; Amarillo, Texas



AMERICAN
BANKRUPTCY
INSTITUTE

DISCOVER



**interactive
code&rules**

law.abi.org

Start Your Research Here






***Your electronic copy of the
bankruptcy code & rules***

With ABI's Code & Rules:

- **Search for a specific provision of the Bankruptcy Code and related Rules**
- **Access links to relevant case law by section (provided by site partner, LexisNexis®)**
- **Retrieve a Code section or case summary – even on your mobile device**
- **Personalize it with bookmarks and notes**
- **Receive it FREE as an ABI member**

Current, Personalized, Portable
law.abi.org

44 Canal Center Plaza • Suite 400 • Alexandria, VA 22314-1546 • phone: 703.739.0800 • abi.org

Join our networks to expand yours:   

© 2011 American Bankruptcy Institute All Rights Reserved.

**CUTTING-EDGE ISSUES IN AGRICULTURAL
BANKRUPTCIES**

Joe Hawbaker,

Hawbaker Law Office, Omaha, NE

Phillip L. Kunkel,

Gray, Plant, Mooty, Mooty & Bennett, St. Cloud, MN

Hon. Thomas L. Saladino,

U.S. Bankruptcy Court (D. Ne.), Lincoln, NE

Don D. Sunderland,

Mullin Hoard & Brown, LLP, Amarillo, TX

I. DISCHARGING TAX IN CHAPTER 12: THE SUPREME COURT TAKES UP § 1222(a)(2)(A)

A. Background

On June 13, 2011, the United States Supreme Court granted certiorari in *United States v. Hall*, 617 F.3d 1161 (9th Cir. 2010), cert. granted (No. 875, 2010 Term.). At issue is the meaning of Section 1222(a)(2)(A) of the Bankruptcy Code, enacted in 2005 as part of the Bankruptcy Abuse Prevention and Consumer Protection Act (“BAPCPA”). Section 1222(a)(2)(A), which took effect on April 20, 2005, appears to afford a Chapter 12 debtor the power to strip tax claims of priority status and to treat them as general unsecured claims.

Section 1222 in general governs the contents of a Chapter 12 plan. Among other things, it requires full payment of claims entitled to priority under Section 507. Section 1222(a)(2)(A) creates an exception to this requirement for a claim “owed to a governmental unit that arises as the result of the sale, transfer, exchange, or other disposition of any farm asset used in the debtor’s farming operation.” Such a claim “shall be treated as an unsecured claim that is not entitled to priority under section 507, but the debt shall be treated in such manner only if the debtor receives a discharge.”¹

Three principal questions have arisen and been litigated concerning the meaning and application of Section 1222(a)(2)(A).² Does the Section apply only to capital gain tax?³ Assuming the application of § 1222(a)(2)(A), what is the proper allocation of taxes entitled to priority and non-priority treatment? Does § 1222(a)(2)(A) apply to tax that arises post-petition, or only to pre-petition tax? It is in answering this final question that a split of authority has

¹ § 1222 does not specify that the discharge occurred under § 1228. An issue which has not yet found its way into court is whether or not in a discharge under § 727 (in a post-confirmation conversion of a Chapter 12 to Chapter 7) the tax liability would retain its unsecured, nonpriority status and so be discharged. Does the priority stripping power of 1222 survive conversion and carryover into the 727 discharge?

² This discussion focuses primarily on the issue that has been taken up to the Supreme Court. The other issues are only briefly discussed.

³ This question was not addressed in *United States v. Hall*, but rather in *Knudsen v. IRS*, 581 F.3d 696 (8th Cir. 2009). The 8th Circuit case decided that § 1222(a)(2)(A) is not restricted to capital gain tax. See discussion below.

occurred. The Eighth Circuit holds that § 1222(a)(2)(A) does apply to both pre-petition and post-petition taxes; the Ninth Circuit and Tenth Circuit hold that § 1222(a)(2)(A) does not apply to post-petition taxes.

Section 1222(a)(2)(A) applies only to “claims entitled to priority under 507.”⁴ Section 507 includes only two categories of taxes that are entitled to priority treatment: 1) pre-petition taxes allowed under § 507(a)(8), and 2) post-petition taxes that qualify under § 507(a)(2). Section 507(a)(2) accords priority to “administrative expenses allowed under § 503(b).” Section 503(b)(1)(B)(i) in turn allows an administrative expense for “any tax...incurred by the estate.”⁵ The circuits essentially disagree over the meaning and significance of the phrase “incurred by the estate” as it appears in § 503(b)(1)(B)(i). The Ninth Circuit and Tenth Circuit interpret the phrase to require the existence of a taxable entity legally capable of incurring liability for a tax. They find, principally in reliance on the Internal Revenue Code, 26 U.S.C. §§ 1338 and 1339, that a Chapter 12 estate cannot incur tax. In that the Chapter 12 estate cannot incur liability for a tax, any tax that arises post-petition is not a priority administrative expense and therefore not subject to treatment under § 1222(a)(2)(A). The Eighth Circuit interprets the phrase “incurred by the estate” to mean incurred post-petition and, in reliance primarily on the intent of the statute as determined from its language and from legislative history, declines to interpret the phrase in the context of the Internal Revenue Code.

The Supreme Court has framed the question presented as follows:

After filing a Chapter 12 bankruptcy petition, Petitioners sold their family farm with the consent of their bankruptcy trustee and court approval, and with sale proceeds administered through the bankruptcy estate to pay creditors. Internal Revenue Code § 1399 provides that a bankruptcy filing other than an individual Chapter 7 or individual Chapter 11 does not give rise to a "separate taxable entity." Does that IRC provision mean that the capital gains income tax incurred

⁴ 11 U.S.C. § 507. Priorities.

⁵ 11 U.S.C. § 503(b)(1)(B)(i). Section 503, Allowance of Administrative Expenses.

due to the sale of the farm is not a Bankruptcy Code administrative expense owed by the bankruptcy estate and payable under a bankruptcy reorganization plan? If so, Bankruptcy Code § 1222(a)(2), enacted to provide special treatment of such family farmer administrative expenses, would not apply or permit Petitioners to satisfy the tax as an unsecured claim that is not required to be paid in full.⁶

B. The Cases

1. KNUDSEN and SCHILKE – EIGHTH CIRCUIT

The first appellate decision on § 1222(a)(2)(A) was handed down by the Eighth Circuit in *Knudsen v. IRS*, 581 F.3d 696 (8th Cir. 2009). This decision came in the consolidated appeals of an Iowa case, *In re Knudsen*,⁷ and a Nebraska case, *In re Schilke*.⁸ The debtor in *Knudsen* had sought § 1222(a)(2)(A) treatment for the tax liability arising out of the pre-petition liquidation of its swine herd, including the sale of both breeding livestock (sows and boars) and market livestock (slaughter hogs). The debtor also sought § 1222(a)(2)(A) treatment for the post-petition sale of machinery and real estate. The appeal in *Knudsen* involved three principal issues: 1) Should § 1222(a)(2)(A) treatment be limited to capital gain liability? 2) How should the § 1222(a)(2)(A) treatment be allocated against taxes, and 3) Is § 1222(a)(2)(A) applicable to post-petition claims?

In *Schilke*, the debtor sold real estate and breeding livestock post-petition pursuant to an approved motion to sell and then provided in the Chapter 12 plan that the liability incurred through those sales would be treated under § 1222(a)(2)(A) as a general unsecured claim subject to discharge. The *Schilke* appeal involved the application of § 1222(a)(2)(A) to post-petition claims.

i. *The Capital Gain Issue.* In *Knudsen*, the IRS argued that market hogs, as opposed to the breeding livestock, or sows and boars, were not *used* in the debtor's farm

⁶ <http://www.supremecourt.gov/Search.aspx?FileName=/docketfiles/10-875.htm>.

⁷ 356 B.R. 480 (Bankr. N.D. Iowa 2006).

⁸ 379 B.R. 899 (Bankr. D. Neb. 2007).

business but were the products of that business. The IRS argued that the § 1222(a)(2)(A) phrase “used in the debtor’s farming operation” should have the same meaning as the phrase “property used in a trade or business” as found in the Internal Revenue Code, 26 U.S.C. § 1231(b)(3). In other words, that § 1222(a)(2)(A) should be limited to treatment of capital gain tax. The IRS prevailed on this issue in the bankruptcy court but lost in the district court. The Eighth Circuit agreed⁹ with the district court and reversed the bankruptcy court’s judgment that the slaughter hogs were not a “farm asset used in the debtor’s farming operation.”¹⁰

ii. *The Method of Allocation.* Assuming § 1222(a)(2)(A) applies to a tax claim, the question arises as to the proper allocation of that treatment in the return. To simplify, the IRS argued for use of the “proration or proportional method” under which the tax owing would be reduced by the percentage of income attributable to sales of § 1222(a)(2)(A) assets. The debtor argued for use of the “marginal method” under which all § 1222(a)(2)(A) qualifying income is removed from the return, in effect treating the qualifying income as the “last dollars in” and therefore subject to the highest marginal tax rate. The debtor’s method has the advantage to the debtor of potentially reducing the rate of tax on the non-qualifying income. The bankruptcy court had ruled against the debtor and ordered application of the proportional

⁹ A dissenting opinion in the Eighth Circuit *Knudsen* decision rejected the extension of § 1222(a)(2)(A) treatment to tax arising from the disposition of non-capital gain assets.

¹⁰ Although considerable portions of both the Eighth Circuit and Iowa district court decisions dealt with this capital gain question, it is an issue that appears will not be taken up by the Supreme Court. However, the Eighth Circuit in *Knudsen* in part supported its decision rejecting the capital gain restriction by stating that: “§ 1222(a)(2)(a) is not a federal income tax provision found in the Bankruptcy Code; instead, it is a priority-stripping provision that applies to any tax claim—federal, state, or local. Therefore, we decline to apply the § 1231 of the IRC in the bankruptcy context and instead rely on the provisions of the Bankruptcy Code itself in interpreting § 1222(a)(2)(A).” The Supreme Court’s interpretation of the interplay between the IRC and the Bankruptcy Code could implicate this part of the *Knudsen* decision. This capital gain issue has also arisen and been decided in favor of the debtor in *In Matter of Uhrenholdt*, BK06-40787-TLS (Bankr. Neb. 1/26/2009), and *In re Ficken*, 430 B.R. 663 (10th Cir. B.A.P. 2010).

method. Both the district court and the Eighth Circuit reversed the bankruptcy court's decision on use of the proportional method, citing policy reasons in the face of statutory silence.¹¹

iii. *The Post-Petition Taxes Issue.* The IRS made three arguments for the inapplicability of § 1222(a)(2)(A) to post-petition taxes. It argued that 1) a Chapter 12 Plan cannot bind holders of post-petition claims because they are not "creditors" within the meaning of 11 U.S.C. § 101(10)(A) and the plan can only bind creditors under § 1227;¹² 2) the government had not waived its sovereign immunity with respect to § 1222(a)(2)(A); and 3) income tax claims arising from the post-petition sale of assets do not constitute an "administrative expenses" under 11 U.S.C. § 503(b)(1)(B)(i).

The Iowa bankruptcy court found that taxes incurred post-petition by individual debtors can be administrative expenses for purposes of payment under the plan. "In a bankruptcy case, the payment of a tax imposed against a debtor may still be 'divided, into separate components in accordance with the bankruptcy laws determining the priority of payment of those claims,'" citing *Missouri Dept. of Revenue v. L.J. O'Neill Shoe Co. (In re L.J. O'Neill Shoe Co.)*, 64 F.3d 1146, 1152 (8th Cir. 1995).¹³ The court relied on *O'Neill Shoe* to find that "even though [the debtor's] chapter 12 estate is not a separate taxable entity, [their] plan may provide for payment

¹¹ The issue of allocation has arisen in other cases, namely *In the Matter of Rickert*, BK06-40253-TLS (Bankr. Neb. 1/9/2009) (Bankr. Neb., 2009), and *In re Ficken*, id. In *Rickert*, decided before the Eighth Circuit *Knudsen* decision, the Nebraska bankruptcy court, like the bankruptcy court in *Knudsen*, preferred the proportional method.

¹² This issue also arose in Ninth Circuit decision in *Hall*.

¹³ *O'Neill Shoe* involved a Chapter 11 corporate debtor. Such a debtor is not deemed to be a taxable estate under IRC §§ 1338 and 1339. In trying to determine which claim at issue would be allowed as an administrative expense, *O'Neill Shoe* provides in relevant part as follows: "Under the terms of [11 U.S.C. Sec. 503(b)(1)(B)(i)], the tax claim must satisfy a "two-prong test" to qualify as an administrative expense claim. City of New York, Dept. of Finance v. R.H. Macy & Co. (In re R.H. Macy & Co.), 176 B.R. 315, 316-17 (S.D.N.Y.1994) (citing *In re O.P.M. Leasing Serv., Inc.*, 68 B.R. 979, 982 (Bankr.S.D.N.Y.1987)). First, the tax must be "incurred by the estate." Id. Second, the tax must not be 'specified in section 507(a)(7).' Id. Section 507(a)(7) provides a seventh priority in distribution to certain types of tax claims. If either of these two requirements is not satisfied, then the claim is not entitled to administrative expense treatment. The bankruptcy court and the district court both held that while the entire corporate tax was "incurred by the estate" (i.e.--incurred postpetition), the portion of the tax attributable to prepetition income was "of a kind specified in section 507(a)(7)."

of taxes arising from income earned after the filing of the petition, and such taxes may be treated for distribution purposes as administrative expenses under 11 U.S.C. § 503(b)(1)(B).”

In June 2008, the district court for the northern district of Iowa affirmed *inter alia* the bankruptcy court’s ruling that § 1222(a)(2)(A) applies to post petition taxes.¹⁴ The court found that nothing in the plain language of § 1222(a)(2)(A) restricts its applicability to pre-petition sales (citing *Schilke*). The district court agreed with the IRS that the filing of a Chapter 12 does not establish the Chapter 12 estate as a separate taxable entity. However, the court stated, “that is not the end of the matter...the issue turns on the meaning of the terms in the Bankruptcy Code...and principles of bankruptcy law.” (*Knudsen*, 389 B.R. at 677.) The court went on to find that the meaning under §503(b)(1)(B) of the phrase “incurred by the estate” is ambiguous,¹⁵ and after a discussion of the legislative history of § 503(b), held that the phrase “incurred by the estate” refers to the *time* when the tax liability is incurred rather than to the existence of the estate as a taxable entity. (*Knudsen*, 389 B.R. at 680.) The court also discussed *O’Neill Shoe’s* support for this interpretation of the phrase “incurred by the estate.” In addition, the court stated that legislative history supports the application of § 1222(a)(2)(A) to post-petition taxes.¹⁶ Citing *Dawes* and *Schilke*, the court also found that to adopt the IRS interpretation would render the statute meaningless for most debtors as it would apply only to the farmers who had the foresight

¹⁴ *In re Knudsen*, 389 B.R. 643 (N.D. Iowa 2008).

¹⁵ The district court cited *In re Dawes*, 382 B.R. 509 (Bankr. Kan. 2008), discussed *below*, in support of its holding that the phrase is ambiguous.

¹⁶ 145 Cong. Rec. S570-02, S764, 1999 WL 20426 (Jan. 20, 1999), (statement of Senator Grassley on S.260). “Senator Grassley referred to the need to relieve family farmers seeking reorganization from the “crushing tax liability if they need to sell livestock or land in order to reorganize their business affairs” and from the need to pay the IRS in full “for any tax liabilities generated during a bankruptcy reorganization.” 389 B.R. at 676. Note that Senator Grassley made this statement approximately six years prior to enactment of § 1222(a)(2)(A). It occurred as part of a prior, failed effort to enact identical language into the bankruptcy code.

to liquidate assets before filing and would provide no benefit in a reorganization involving the sale of assets.¹⁷

In *Schilke*, the Nebraska bankruptcy court, finding that the intent of the statute is to help farmers reorganize, agreed with Knudsen that § 1222(a)(2)(A) ought to apply to post-petition taxes.

[T]he language of § 1222(a)(2)(A) indicates that it was intended to apply to taxes arising during the Chapter 12 proceeding. Specifically, it refers to ‘a claim owed to a governmental unit that *arises* as a result of the sale, transfer, exchange, or other disposition of any farm asset used in the debtor's farming operation....’ (Emphasis added.) To interpret § 1222(a)(2)(A) as being inapplicable to taxes arising post-petition is effectively adding language to the statute that simply is not there.

Further even though a Chapter 12 bankruptcy estate is not a separate taxable entity, the estate does exist nonetheless. The estate consists of all property of the debtor on the date of filing, all property that the debtor acquires after commencement of the case, and all earnings from services performed by the debtor after commencement of the case. 11 U.S.C. § 1207(a). [] The taxes at issue are created by the sale of property of the estate by Debtor. I do not believe that the language of § 503(b)(1)(B) regarding any tax ‘incurred by the estate’ was intended to apply only to those situations where the estate itself is a separate taxable entity. In fact, ‘incurred by the estate’ has been interpreted to simply mean incurred post-petition. *L.J. O'Neill Shoe Co.*, 64 F.3d at 1149 (stating “[t]he bankruptcy court and the district court both held that while the entire corporate tax was ‘incurred by the estate’ (i.e. — incurred post-petition). ...”). Here, there clearly is an estate, the tax is the result of a sale of property of the estate, and Debtor happens to be liable for that tax.” (379 B.R. at 902-903.)

On appeal, the district court for Nebraska affirmed *Schilke*.¹⁸

The Eighth Circuit, on the issue of the applicability of § 1222(a)(2)(A) to post-petition taxes in the consolidated appeals for *Knudsen* and *Schilke*, affirmed the bankruptcy courts. It supported its decision that § 1222(a)(2)(A) applies to post-petition taxes on several grounds.

¹⁷ “In fact, if [§ 1222(a)(2)(A)] is inapplicable to post-petition taxes as the IRS suggests, the statute becomes meaningless for most debtors as it provides no benefit in a reorganization involving the sale of assets used in a farming operation. Chapter 12 expressly contemplates that a plan may provide for the sale of property of the estate. 11 U.S.C. § 1222(b)(8).” *Schilke*, 379 B.R. at 903.

¹⁸ *In re Schilke*, No. 4:07 CV 3283, 2008 U.S. Dist. LEXIS 68176 (D. Neb. Sept. 9, 2008).

First, it found that nothing in the plain language of the statute restricts its application to pre-petition sales. Second, as supported by *O'Neill Shoe*, it found that “incurred by the estate” means incurred post-petition. Third, it rejected the IRS argument that for the tax to be “incurred by the estate” required the existence of a separate taxable entity. The court said: “[I]t is the IRC, not the Bankruptcy Code, that creates a ‘separate taxable entity’ upon the filing of petitions by individuals under Chapters 7 and 11 but does not create a separate taxable entity in cases filed by individual debtors under Chapters 12 and 13.” (581 F.3d at 709.) The court added that even though there is no separate taxable entity in a Chapter 12 case, an “estate” still exists, pursuant to § 1207.¹⁹ Finally, the court noted that most cases which had considered the issue reached the same conclusion.²⁰

2. HALL – NINTH CIRCUIT

Certiorari has been granted in the appeal of the Ninth Circuit’s decision in *United States v. Hall*, 617 F.3d 1161 (9th Cir. 2010), cert. granted (No. 875, 2010 Term.). In *Hall*,²¹ the debtors sold their 320 acre farm post-petition and moved to treat the \$29,000 capital gain arising from the sale as an unsecured claim under § 1222(a)(2)(A). The Arizona bankruptcy court found *Knudsen*’s reliance on *O'Neill Shoe* “misplaced.” According to the court, *O'Neill Shoe* did not answer the precise question at issue, which was “whether a Chapter 12 estate can incur a federal capital gains tax liability that arises post-petition.” (376 B.R. at 745.) *Hall* chose to follow *In re*

¹⁹ See *Schilke* supra at 902.

²⁰ Citing among others *W. Va. State Dep't of Tax & Revenue v. I.R.S. (In re Columbia Gas Transmission Corp.)*, 37 F.3d 982, 984 (3d Cir.1994), and *In re Northeastern Ohio Gen. Hosp. Ass'n*, 126 B.R. 513, 515 (Bankr.N.D.Ohio 1991). 581 F.3d at 709.

²¹ *In re Hall*, 376 B.R. 741 (Bankr. Ariz., 2007).

Brown,²² a Chapter 13 case out of the Massachusetts bankruptcy court, in finding that § 503(b)(1)(B)(i) simply does not answer the question of what it means for a tax to be incurred by the estate. The *Hall* court agreed with *Brown* that “§ 503(b)(1)(B)(i) must be read in conjunction with 26 U.S.C. §§ 1398 and 1399 of the Internal Revenue Code.” (376 B.R. at 746.) *Hall* stated that in statutory interpretation the language of the statute is the starting point but that the language must be viewed in context, and the *Hall* court found that the context in deciding the § 1222(a)(2)(A) issue “includes the interplay between the Bankruptcy Code as amended by BAPCPA, and the Internal Revenue Code of 1986.” (376 B.R. at 746.) In support of this reliance on the Internal Revenue Code for its interpretation of § 1222, the *Hall* bankruptcy court quoted the maxim that courts are to “assume that Congress is aware of existing law when it passes legislation.” (376 B.R. at 746, citing *Miles v. Apex Marine Corp.*, 498 U.S. 19 (1990).)

In August 2008, the federal district court for Arizona, in the debtor’s appeal from *Hall*, rejected the bankruptcy court’s decision.²³ The district court concurred with the application of *Knudsen* in *Dawes*²⁴ and it concurred with and adopted the *Schilke* analysis. Although it rejected the bankruptcy court’s critique of *O’Neill Shoe*, the court stated that “based on Congressional intent,” without reliance on *Knudsen* or *O’Neill*, it found that “Chapter 12 post-petition capital gains are administrative expenses” (393 B.R. at 862.) The court nonetheless found *O’Neill Shoe* to be supportive in that 1) allowance of administrative claims as entitled to priority is so well established that it does not matter that the administrative claim status was not litigated in

²² *In re Brown*, No. 05-41071, 2006 Bankr. LEXIS 3156 (Bankr. D. Mass. Nov. 20, 2006). In *Brown*, the Chapter 13 debtor sought to treat capital gain taxes arising from the post-petition sale of his rental property as an administrative claim for which the estate was liable, and which would be paid under the Chapter 13 Plan. *Brown* argued that since the property that was sold was property of the bankruptcy estate when it was sold, the estate should be liable for payment. A creditor objected (though the trustee did not) arguing that under § 1305 a tax creditor may pursue payment directly from the debtor after the case is closed. The court found that the treatment of post-petition taxes as a priority claim under § 503(b)(1)(B)(i) does not apply in Chapter 13 cases because there is no taxable estate in Chapter 13 under 26 U.S.C. §§ 1338 and 1339.

²³ *In re Hall*, 393 B.R. 857 (D. Ariz. 2008).

²⁴ 382 B.R. 509 (Bankr. Kan. 2008). See discussion below.

O'Neill; 2) the post-*O'Neill* amendments to § 507 in BAPCPA related to eighth priority claims and were irrelevant; and 3) as in Chapter 12, there was no separate taxable estate created in *O'Neill Shoe*, a fact that supports reliance on *O'Neill* in the § 1222 context. The district court also questioned the bankruptcy court's reliance on the Internal Revenue Code: "Although IRC §§ 1398 and 1399 were in place at the time of BAPCPA, this Court has been unable to find any Chapter 12, or even any Chapter 7 or Chapter 11 case, where those IRC provisions were held to be relevant to the construction of the definition of administrative claim in § 503(b)(2)(B)(i)." (393 B.R. at 863.) The court adopted *Schilke's* reliance on Congressional intent and legislative history. Finally, the district court in *Hall* admonished the IRS that "§§ 1222, 507 and 503 are not federal income tax provisions found in the Bankruptcy Code [] but are properly understood as bankruptcy provisions to be construed in accordance with the Bankruptcy Code and bankruptcy policy to promote the effective reorganization of family farming operations." (393 B.R. at 863.)

In reversing the district court and holding that § 1222(a)(2)(A) does not apply to post-petition taxes, the Ninth Circuit rejected the reasoning of the Eighth Circuit in *Knudsen*.²⁵ The Ninth Circuit essentially held that 1) "incurred by the estate" does not merely mean incurred post-petition because "although all taxes incurred by the estate are incurred post-petition, not all

²⁵ *United States V. Hall*, 617 F.3d 1161 (9th Cir. 2010).

taxes incurred post-petition are incurred by the estate.” (617 F.3d at 1165);²⁶ 2) there is no authority for the proposition that a Chapter 12 bankruptcy estate has an inherent ability to incur taxes nor for the proposition that the Bankruptcy Code as a whole indicates that all estates regardless of chapter have the inherent ability to incur taxes. (617 F.3d at 1166); 3) reliance on IRC §§ 1338 and 1339 is justified because a) the United States Code must be read as a whole, and b) Congress has indicated repeatedly that it is aware that the taxable entity provisions in the IRC are relevant to the Bankruptcy Code; 4) it is irrelevant that the plain language of § 1222(a)(2)(A) does not restrict its application to pre-petition taxes because the cross references in § 1222(a)(2)(A) itself “clearly lead us to the provisions that restrict their reach;” and, 5) even though the court states its sympathy with the approach outline by Senator Grassley in legislative history, there is no need to refer to legislative history in the face of clear statutory language, and even if the court were to refer to legislative history it is unpersuasive both under § 503 and §

²⁶ In support of this view, the 9th circuit referenced two cases. (See Footnote 20 *supra*.) It is not clear how the 9th Circuit believes those cases support its position. Each of the cited cases, which were also cited by the Eighth Circuit in *Knudsen* in support of its decision, seems more clearly to support the position that the critical issue in determining the meaning of “incurred by the estate” under § 503 is temporal – when did liability for the tax arise. In *Columbia Gas Transmission*, for example, a Chapter 11 case involving a corporate debtor (a debtor for which no taxable estate is created under the IRC § 1338), the court, in trying to decide what if any part of the corporate tax liability would be given priority status under § 503, stated:

Whether or not *Columbia Gas* is entitled to administrative expense priority for the property taxes depends on which date it “incurred” the property taxes under section 503(b)(1)(B). See 3 *Collier on Bankruptcy*, p 503.04, at 503-34 (15th ed. 1994) (“Whether a tax has been ‘incurred by the estate’ is not always easy to determine. The time of assessment or payment may not be equivalent to the time the tax is incurred for the purpose of establishing priority under section 503(b)(1)(B). Rather, the significant fact may be the date the tax accrues.”) If the property taxes were “incurred by the estate” of *Columbia Gas* on September 15, 1991, the date of the tentative assessment, *the property taxes must be given priority as an administrative expense under section 503*. If, however, before *Columbia Gas* filed its bankruptcy petition the property taxes were incurred in 1990, the period covered by its May 1, 1991 tax return, the property taxes would not be entitled to administrative priority under section 503(b)(1)(B). (Emphasis added.)

It seems clear that the *Columbia Gas* court believes that the corporate Chapter 11 debtor could incur a tax within the meaning of § 503, in spite of the fact that under IRC §§ 1338 and 1339 no taxable estate is created in a corporate Chapter 11 bankruptcy. The same seems true for *In re Northeastern Ohio Gen. Hosp. Ass'n*, 126 B.R. 513, 515 (Bankr. N.D. Ohio 1991).

1222.²⁷ The court conceded that the drafter’s intention for § 1222(a)(2)(A) might differ from the text, but held that its “duty was to follow the text because the text is the law. Congress is entirely free to change the law by amending the text.” (617 F.3d at 1167.)

Circuit Judge Paez dissented from the majority in *Hall*. He found that Congress’s intent was clear and stated that he would follow *Knudsen*, which approach would “honor Congress’s clear intent and avoid an unwarranted circuit split.” (617 F.3d at 1168.)

3. DAWES – TENTH CIRCUIT

In *Dawes*,²⁸ after a prolonged history of litigation which included convictions for tax fraud, the debtors sought § 1222(a)(2)(A) treatment for the capital gain arising from the sale of real estate. The bankruptcy court explicitly found the phrase “incurred by the estate” as it appears in § 503 to be ambiguous. As the court stated: “‘Incurred by the estate’ could have reference to the time liability for a tax accrues — did the liability arise before or after the creation of the estate under § 541. Or, ‘incurred by the estate’ could have reference to the entity liable for the tax — is the bankruptcy estate created under § 541 liable for the tax? Accordingly, the Court will consider legislative history to determine Congressional intent.” (382 B.R. at 515.) The court’s detailed analysis of legislative history led it to conclude that the phrase as it appears in § 503 refers to the *time* when the tax liability is incurred and not whether the estate is a separate taxable entity. The court refused to interpret § 1222(a)(2)(A) in the context of IRC §§ 1399 and 1398: “this Court has been unable to find any Chapter 12, or even any Chapter 7 or Chapter 11 case, where those IRC provisions were held to be relevant to the construction of the

²⁷ The court found the § 503 legislative history unpersuasive because the phrase “taxes which the trustee incurs” has the same meaning as the phrase “taxes which the estate incurs.” It also found the §1222 legislative history unpersuasive because Senator Grassley’s statement as to “tax liabilities generated during a bankruptcy reorganization” actually “concerns an unenacted bill in a Congress convened six years prior to the one that enacted § 1222(a)(2)(A).” (617 F.3d at 1167.)

²⁸ *In re Dawes*, 382 B.R. 509 (Bankr. Kan., 2008).

definition of administrative claim in § 503(b)(2)(B)(i). [] The fact that in a Chapter 12 case a new taxpayer is not created is not relevant to the allowance of post-petition taxes as administrative claims.” (382 B.R. at 520, 521.) The court also made a point of the fact that in prior pre-BAPCPA Chapter 12 cases, the IRS had taken the position that a claim arising from the debtor’s failure to pay post-petition employment taxes as they became due was an administrative expense subject to § 1222(a)(2).

In March 2009, the district court for Kansas affirmed the Kansas bankruptcy court decision in *Dawes*.²⁹ The district court rejected the IRS’s “separate entity” argument for application of IRC §§ 1338 and 1339. It cited for support the bankruptcy court’s discussion of the legislative history behind § 503, the *Knudsen* district court’s reliance on *O’Neill Shoe*, and its holding that nothing in the plan language of § 1222(a)(2)(A) restricts its applicability to pre-petition sales. It agreed with the *Knudsen* district court that since reorganization occurs both before and after the filing of a petition, § 1222(a)(2)(A) must apply to transactions that occur both before and after the petition. The court also quoted *Knudsen*’s admonition to the IRS that the relevant provisions are “not federal income tax provisions found in the Bankruptcy Code but are properly understood as bankruptcy provisions to be construed in accordance with the Bankruptcy code and bankruptcy policy to promote the effective reorganization of family farming operations.” (415 B.R. at 823.)

In June, 2011, shortly after the grant of certiorari by the Supreme Court in *Hall*, the Tenth Circuit reversed the district court in *Dawes* and held that § 1222(a)(2)(A) is not applicable to post petition taxes.³⁰ The court held that post-petition income taxes incurred during the Chapter 12 proceedings are liabilities of the individual debtor and not the bankruptcy estate. “As such

²⁹ *In re Dawes*, 415 B.R. 815 (D. Kan., 2009).

³⁰ *United States v. Dawes (In re Dawes)*, Case No. 09-3129 (10th Cir. June 21, 2011).

they are not within the purview of the bankruptcy proceedings or included in the reorganization plan. Instead, the taxes are due from the debtor personally and the IRS's recourse remains exclusively with the individual debtor, separate and apart from the Chapter 12 estate and unaffected by the bankruptcy discharge." (Page 5.) The court based its holding on the plain language of the statute, the larger statutory structure and Congress's expressed purposes.

First, the court found the plain meaning of the word "incurred" inescapably carries the sense of *being liable for*. "[O]nce we accept that one must be liable for an expense to have incurred it, it is the phrase 'by the estate' that poses the problem for the debtors." (Page 10.) As for reliance on IRC §§ 1338 and 1339, the court wrote:

Of course, Congress is free (and in some cases has chosen) to use the bankruptcy code to control certain aspects of how federal or state tax law operates during reorganizations. But, when the code hasn't told us otherwise, our attention is rightly turned to the underlying tax law to see who owes what. Indeed, bankruptcy law often relies on underlying income tax laws to assign priorities in bankruptcy. See, e.g., § 507(a)(8)(A)(i) (treatment of pre-petition tax turns on when the tax return was due); § 507(a)(8)(B) (treatment of property tax turns on when it was last payable without penalty); § 346 (commanding that state and local income taxes be allocated between debtor and bankruptcy estate in a way that generally follows their treatment under the federal Internal Revenue Code). When the bankruptcy code defers a question to existing tax law, our role is to apply that law, not to invent new rules of our liking. (Pages 6 and 7.)

The court then reviewed §§ 1398 and 1399 to find that "only the debtor and not the estate is liable for the payment" of the post-petition taxes, writing: "The estate may have once possessed the farm assets in question. The bankruptcy court may have authorized their sale. And the estate might well have caused a tax liability to arise. But none of this means the estate incurs those taxes. Only the [debtors] do." (Page 8.)

Second, the court reviewed the larger structure of the Bankruptcy Code and found support for its decision as follows: 1) a review of other § 503 provisions shows that congress was "deliberately navigating the distinction between timing and identity when crafting § 503(b) and

to accept the argument that “incurred by the estate” means incurred post-petition would trample the meaning of those other provisions; 2) to allow that post-petition taxes in Chapter 12 are incurred by the estate would require the same result in Chapter 13, and “[i]f post-petition taxes are automatically included in the bankruptcy plan as taxes ‘incurred by the estate,’ then § 1305(a)(1)'s optional inclusion of these same claims is left loitering around the U.S. Code with no apparent purpose” (Page 12); 3) the Bankruptcy Code specifically prohibits state and local income taxes from being either “taxed to” or “claimed by” a Chapter 12 estate, instead directing that these state and local taxes be the liabilities of the debtor. See § 346(b) (page 12).

Finally, as to the statutory purpose of § 1222(a)(2)(A), the Tenth Circuit stated: “Yet under our interpretation of § 503(b), income taxes incurred as a result of the pre-petition disposition of certain farm assets are eligible for § 1222(a)(2)(A)'s generous rule allowing them to be treated as unsecured claims, compromised, and discharged. [] Clearly, then, our reading gives respect to Congress's wish to provide a substantial form of special assistance targeted to farmers. We only stop short of extending § 1222(a)(2)(A)'s treatment to income taxes incurred post-petition by the debtor rather than the estate.”³¹

II. STATUTORY LIENS, TRUST AND OTHER THINGS THAT GO BUMP IN THE NIGHT

When faced with the failure of an agricultural producer or agribusiness, it is often necessary to confront the plethora of statutory liens, trusts, priorities or other statutory schemes designed by Congress and the several legislatures to protect farmers. Such statutes are often archaic, internally inconsistent, ambiguous and unsupported by any reported case law. As a result, counsel for all parties concerned are frequently confounded by these arcane, and often

³¹ It is interesting to note that on this point there has actually not been an adjudication in the context of § 1222 as to the meaning of post-petition and pre-petition. The Ninth Circuit in *Hall* stated that “there is no dispute that section 1222(a)(2)(A) allows chapter 12 debtors to treat *taxes* incurred by selling farm assets *before* the filing of a bankruptcy petition as payable in less than full and dischargeable.” (617 F.3d at 1163.) But see *In re Firestone*, 179 B.R. 148 (Bankr. D. Neb. 1995); it is not merely the fact of a sale of an asset pre-petition that determines whether or not the tax arising out of the sale is a pre- or post-petition tax.

bizarre, statutes. While the enactment of Revised Article 9 provided some assistance in addressing agricultural liens, not all issues have been addressed. And, as the size and complexity of agricultural businesses continues to grow, the economic consequences of their failures make these issues ripe for litigation.

A. Agricultural Liens Under the UCC

With the enactment of Revised Article 9, agricultural liens acquired a new legitimacy. They were transformed from sometimes secret liens which could trump a security interest into an interest in agricultural collateral which could be enforced by means of all of the remedies available under Article 9. However, it is important to remember that agricultural liens are not treated in the same manner as security interests in agricultural collateral. In fact, there are many differences between the two.

An “agricultural lien” is: “an interest, other than a security interest, in farm products: (A) which secures payment or performance of an obligation for: (i) goods or services furnished in connection with a debtor’s farming operation; or (ii) rent on real property leased by a debtor in connection with its farming operation; (B) which is created by statute in favor of a person that: (i) in the ordinary course of its business furnished goods or services to a debtor in connection with a debtor’s farming operation; or (ii) leased real property to a debtor in connection with the debtor’s farming operation; and (C) whose effectiveness does not depend on the person’s possession of the personal property.” UCC § 9-102(a)(5).

There are two provisions of the definition which warrant special mention: (i) an agricultural lien is a statutory lien created in favor of a person that furnishes goods or services in the “ordinary course of its business;” and (ii) possessory liens are not agricultural liens. Possessory statutory liens are covered by UCC § 9-333. UCC § 9-333(b) grants priority to a

possessory statutory lien unless the lien is created by a statute which expressly provides otherwise.

It is significant that Article 9 applies only to the *perfection* (UCC § 9-310(a)), *priority* (UCC § 9-322(a) and (g)), and *enforcement* (UCC § 9-601(a)) of agricultural liens. An agricultural lien is perfected when it has become effective and the secured party has met all applicable requirements for perfection. UCC § 9-308(b). Other law governs the creation, scope, effectiveness and determinations of default with respect to agricultural liens. (UCC § 9-102(a)(5); Comment 12, UCC § 9-322; UCC § 9-606). It is thus necessary to look to the applicable state law to determine whether a lien claimant is entitled to an agricultural lien as well as the scope of any such lien.

B. States' Enactment of Revised Article 9

1. Iowa. Iowa has adopted Revised Article 9 as to the treatment of agricultural liens. The law relating to the creation, scope, effectiveness and determinations of default for agricultural liens is found in Iowa Code § 554.9102(a)(5), Iowa Code § 554.9322, and Iowa Code § 554.9606.³² A review of a specific Iowa agricultural lien is helpful as an example of a state adopting the Revised Article 9 and having statutory agricultural liens that incorporate additional requirements. A recent issue in Iowa is whether a feed supplier must provide a written lien notification statement to a lender to be entitled to a priority agricultural supply dealer's lien under Iowa Code § 570A.

Iowa Code § 570A.2 provides the language at issue. If the lien notification is required, and a party fails to provide such a notice, the supplier would fail to have an enforceable lien as to

³² Iowa has also adopted several non-UCC Statutory Agricultural liens including the Landlord's Lien (Iowa Code § 570.1-570.10), the Agricultural Supply Dealer's Lien (Iowa Code § 570A.1-570A.11), the Harvester's Lien (Iowa Code § 571.1A-571.5) the Forwarding and Commission Merchant's Lien (Iowa Code § 576.1-576.2), the Lien for Service of Animals (Iowa Code § 580.1-580.9), and others.

a secured lender. Alternatively, if the lien notification statement is not required, Iowa Code § 570A.2(3) provides an affirmative defense to a secured creditor.

Five recent court decisions have weighed in on whether this lien notification is required and/or whether the failure to give the notification is an affirmative defense for the lender. Three decisions have held that the lien notification is required and/or that the failure to give the notification is an affirmative defense of the lender.³³ See *Crooked Creek Corp v. PrimeBank, et al. (In re Crooked Creek Corp.)*, Case No. 09-9093S (Bankr. N.D. IA May 7, 2010); *First National Bank of Omaha v. Farmers Cooperative Society, et al (In re Coastal Plains Pork, LLC)*, Adversary No. 09-00214-8 (Bankr. E.D. N.C. July 23, 2010); and *Galva-Holstein Ag, LLC v. Holstein Dairy, LLP*, Ida County (Iowa Dist.) Case No. EQCV014128 (May 7, 2010). However, two Iowa state court decisions exist where the court held that the lien notification is not required and the failure to give the notification is not an affirmative defense of the lender. See *Doon Elevator Company v. American State Bank*, Sioux County (Iowa) Case No. LACV022572 (March 29, 2010); and *First State Bank v. Kerber Milling*, Clay County (Iowa) Case No. CVCV027234 (August 2, 2010). As of the date of this publication, the legal issue as to whether or not the lien notification must be sent under Iowa Code § 570A.2 was certified to the Iowa Supreme Court, has been fully briefed and is awaiting oral argument. See *Oyens Feed & Supply v. Primebank*, Docket No.: 11-0532.

2. Minnesota. Minnesota has adopted Revised Article 9 in regards to the treatment of agricultural liens. Minnesota law governing the creation, scope, effectiveness and

³³ In addition, the Iowa Supreme Court has stated in a footnote that when a feed supplier failed to provide a bank with the required documentation, any lien under Iowa Code § 570A was “ineffective” as against the bank. *Wilkin Elevator v. Bennett State Bank*, 522 N.W.2d 57, 62 n. 3 (Iowa 1994). Iowa Code §554.9308(2) provides that “[a]n agricultural lien is perfected if it has become effective...”. The “required documentation” referred to by the Court was the lien notification required by Iowa Code § 570A.2. Ultimately, the Iowa Supreme Court concluded that the bank was entitled to the third party checks for the sale of the hogs.

determinations of default with respect to agricultural liens can be found at Minn. Stat. § 336.9-102(a)(5), Minn. Stat. §336.9-322, and Minn. Stat. § 336.9-606. Minnesota's non-UCC statutory agricultural liens were significantly revised in light of the passage of the Article 9 revisions. They are found in Minn. Stat. §§ 514.963-514.966.

3. Missouri. Missouri has also adopted the Revised Article 9 regarding the treatment of agricultural liens, and the state's adopted version of the UCC can be found in Chapter 400 of the Missouri Revised Statutes. The law governing the creation, scope, effectiveness and determinations of default as to agricultural liens in Missouri can be found at Mo. Rev. Stat. § 400.9-102(a)(5), Mo. Rev. Stat. § 400.9-322, and Mo. Rev. Stat. § 400.9-606. Some of Missouri's non-UCC statutory agricultural liens are found in Mo. Stat. §§ 272.030-230 and § 430.010-300.

4. Kansas. Kansas is the only state to reject Revised Article 9's treatment of agricultural liens. The Revised Article 9 definition of agricultural lien is included in Kansas's Article 9, however, it excludes agricultural and statutory liens from the UCC filing system by way of adopting nonstandard versions of § 9-102(5) and § 9-102(76). Kan. Stat. § 84-9-102(5) defines "agricultural lien" in a uniform way, but adds "[a]gricultural lien shall not include statutory lien." Kan. Stat. § 84-9-102(75) defines statutory liens and includes many agricultural liens. As a result, the Kansas statutory liens relating to agriculture vary in regards to how a lien is created, perfected and enforced. These liens are subject to other statutory filing requirements; a UCC lien search will not find such liens. Some of Kansas's non-UCC statutory agricultural liens are found in Kan. Stat. §§ 47-123-124; 638; 2001-2007; 58-201-246; 58-215-2525.

C. Specific Issues Under Revised Article 9

1. Choice of Law. UCC § 9-302 creates a significant exception to the general choice of law rules in Article 9 relevant to agricultural financing. That section provides that the law of the jurisdiction in which *farm products are located* governs perfection, the effect of perfection or nonperfection, and the priority of an agricultural lien. Other choice of law rules (e.g., UCC § 1-105) will determine which jurisdiction's law governs other matters, such as the secured party's rights on default. Comment 2, UCC § 9-302; Example 10, Comment 7, UCC § 9-316. This choice of law provision will require secured parties who are relying upon an agricultural lien to perfect their agricultural lien by filing a financing statement in the state to which farm products are transported by the debtor if they are removed from the state in which they were produced. For example, if cattle are fed in an Iowa feedlot, then transported to South Dakota for slaughter, the Iowa feedlot operator must perfect in South Dakota, as well as Iowa, in order to remain perfected. In addition, while a creditor with a security interest in farm products has a four-month grace period within which to file if the debtor changes its location, there is no such grace period when farm products subject to an agricultural lien are moved to another state. UCC § 9-316(a).

In *Stockman Bank of Montana v. Mon-Kota, Inc.*, 180 P.3d 1125 (Mont. 2008), the Montana Supreme Court addressed this issue when it had to determine which jurisdiction's law governed the perfection of an asserted agricultural lien. The debtor was a North Dakota corporation and thus, the secured creditor argued that North Dakota law governed. The court noted that this was the rule as to security interests, but reiterated its earlier made point that agricultural liens are *not* security interests. Mont. Code § 30-9A-302 states that the law of the state where "farm products are located" must govern." When the lien was created, the farm products were located in Montana and thus, Montana law was the "local law" that would govern

the lien's perfection. The court ultimately held that the lienholder was not required to perfect the lien under North Dakota law, but rather, because Montana law governed, the lienholder was required to file with the Montana Secretary of State as it had done.

2. Perfection. Under Article 9, an agricultural lien must be perfected in order to obtain any priority over competing security interests and other agricultural liens since conflicting security interests and agricultural liens are generally afforded priority on a first to file or perfect basis. UCC § 9-322(a). An agricultural lien is perfected if it has become effective and all of the applicable requirements for perfection under Article 9 have been satisfied. UCC § 9-308(b). A financing statement must be filed in order to perfect an agricultural lien. UCC § 9-310(a). Possession is not available as a means of perfection for agricultural liens. UCC § 9-313(a).

In a recent Montana case, a Chapter 12 debtor was supplied with herbicides and fertilizers prior to, and after, the petition date by an input supplier. The supplier perfected its agricultural liens after the debtor filed its bankruptcy petition for the prepetition and postpetition supplies. The debtor argued that the creditor was not allowed to perfect its lien postpetition because the automatic stay prohibited it. The court disagreed with the debtor and held that pursuant to 11 U.S.C. §§ 362(b)(3) and 546(b), the filing of a bankruptcy petition does *not* stay actions for perfecting an agricultural lien regardless of whether the lien is both created and perfected upon the filing of a financing statement. *In re Aznoe Agribiz, Inc.*, 416 B.R. 755 (Bankr. D. Mont. 2009).

3. Proceeds. UCC § 9-315(a) provides that a security interest or an agricultural lien continues in collateral notwithstanding its sale, lease, license, exchange or other disposition unless the secured party authorized the disposition free of the security interest or

agricultural lien. However, UCC § 9-315(a)(2) provides that only a security interest attaches to identifiable proceeds of collateral. If the enabling statute provides that an agricultural lien arises in such proceeds, then the rules of Article 9 applicable to agricultural liens will apply to the lien on such proceeds. Comment 9, UCC § 9-315.

A recent case in Montana addressed the issue whether proceeds were subject to an agricultural lien. See *Stockman Bank of Montana*, 180 P.3d 1125. In *Stockman Bank*, a farm raised sugar beets in North Dakota and Montana. A bank loaned money to the farm and to secure the indebtedness the bank took a security interest in the farm products of the farm. The bank filed UCC-1 finance statements in North Dakota and Montana. A crop input supplier supplied chemicals to the farm in North Dakota and Montana. The purchase of those chemicals was financed by a separate financier that filed an agricultural supplier's lien in Montana. The Montana Supreme Court held that the enabling statute must provide that the lien extends to the proceeds of the collateral under UCC § 9-315, Comment 9. Since the Montana lien statute was silent as to the proceeds of the collateral, the court held that the lien did not extend to proceeds of the collateral. The court noted that any reference to attachment of an agricultural lien to proceeds was "noticeably absent" and therefore the Montana lien did not extend to the crop proceeds. However, in *Crooked Creek Corp. v. Primebank and Oyens Feed & Supply, Inc. (In re Crooked Creek Corp.)*, No. 09-09093, (Bankr. N.D. IA. May 7, 2010), the Iowa Bankruptcy Court concluded in a footnote that if the dealer had a valid agricultural lien on debtor's livestock at the time of the filing of a bankruptcy petition, the lien was effectively transferred to the proceeds created by the post-petition sales of livestock. According to that court, that transfer in that case was effectuated by an agreement of the parties and the court's order approving the post-petition agreement. The agreement and order preserved the status quo in the bankruptcy case,

notwithstanding that neither the Iowa Code Chapter on agricultural liens nor the UCC gave the dealer a valid supply dealer lien a continuing lien in the proceeds.

4. Priority. As with security interests, agricultural liens generally have priority according to priority in time of filing or perfection. UCC § 9-322(a)(1). A perfected agricultural lien has priority over a conflicting unperfected security interest or agricultural lien. UCC § 9-322(a)(2). The first security interest or agricultural lien to attach or become effective has priority if a conflicting security interest or agricultural lien is unperfected. UCC § 9-322(a)(3).

Significantly, however, UCC § 9-322(g) provides that if a statute under which an agricultural lien in collateral is created provides that the agricultural lien has priority over a conflicting security interest or agricultural lien in the same collateral, the statute governs priority if the agricultural lien is perfected. Thus, individual states may opt out of the first to file or perfect priority rule of Article 9 with respect to agricultural liens. For example, the revisions to Minnesota's agricultural lien statutes take advantage of this provision by establishing specific priority rules for agricultural liens which may be different than the general "first to file or perfect" priority rule of Article 9. See, e.g., Minn. Stat. §§ 514.964, 514.966.

D. Other Statutory Liens and Trusts

In addition to agricultural liens, there are numerous examples of other statutory liens and trusts which may affect an agribusiness case. As with agricultural liens, these liens may, or may not, be clear on their face as to their application, scope and priority.

1. Agricultural Producer Liens. Many states have agricultural producer liens which provide for a statutory lien on all agricultural commodities produced by a farmer. See, e.g., Minn. Stat. § 514.945. California's agricultural producer's lien is typical. Cal. Ag. Code §

55631 et seq. Under the California scheme, every producer who sells any product to a processor has a lien upon such products and upon all processed products. The lien attaches upon delivery and is superior to all other liens, claims or encumbrances except labor claims and a warehouseman's lien under the UCC. While the lien does not, by its express terms, extend to proceeds, case law has done so. See, *Frazier Nuts v. American Ag Credit*, 2006 Cal App Lexis 1190 (2006).

In *In re Symons Frozen Foods Inc.*, 432 B.R. 290 (Bankr. W.D. Wash. 2010), a debtor failed to pay a producer that sold sweet corn to the debtor pursuant to a "Corn Agreement." The lien automatically arose under operation of law, and no action was necessary to attach or perfect the lien. However, the producer was required to take action in order for the lien not to expire at the end of the 45th day after final payment was due by filing a notice of the lien with the Oregon Secretary of State. The producer filed such notice in compliance with the statute and the court held that the producer had a valid lien under Oregon law. Upon the debtor filing a Chapter 11 bankruptcy petition, the producer asserted its lien but the court held that the Oregon agricultural produce lien was outside the definition of an "agricultural lien" under Revised Article 9. This was because UCC § 9-102(a)(5) is limited to goods or services provided to the debtor and *not* goods or services provided by the debtor. As a result of that conclusion, the attachment, perfection and priority rules of the state statute did not apply; rather, the attachment, perfection and priority rules of Article 9 applied and the producer did not have a valid lien under Article 9.

2. Packers and Stockyards Act: Statutory Trust. Although the Packers and Stockyard Act ("PSA") was originally primarily an antitrust measure, in 1976 Congress amended the statute to include a statutory trust provision. The PSA establishes a statutory trust for livestock purchased by a packer whose average annual purchases exceed \$500,000. The PSA

provides that “[a]ll livestock purchased by a packer in cash sales, and all inventories of, or receivables or proceeds from meat, meat food products, or livestock products derived therefrom, shall be held by such packer in trust for the benefit of all unpaid cash sellers of such livestock until full payment has been received by such unpaid sellers....”³⁴ The PSA trust applies only to “cash sales” i.e. sales in which the seller does not expressly extend credit to the buyer.³⁵

Because the packer holds the PSA-trust assets for the benefit of the seller, in the event the packer files for bankruptcy, the PSA-trust assets do not become “property of the estate” pursuant to Bankruptcy Code § 541 as the packer does not have an equitable interest in the trust assets. As a result, unpaid cash sellers do not compete with secured creditors for the trust’s assets.

To make a claim against the trust, the unpaid cash seller must give notice to the packer and file such notice with the Secretary of Agriculture within thirty (30) days of the final date for making payment under § 228b of the PSA or within fifteen (15) business day of being notified that the payment of a promptly presented check was dishonored.

3. Perishable Agricultural Commodities Act: Statutory Trusts. In response to complaints that dealers were buying produce but either failing to pay or unreasonably delaying payment to suppliers and sellers, Congress amended the Perishable Agricultural Commodities Act (“PACA”) in 1984 to include statutory trust provisions. The PACA trust provisions were modeled after the statutory trust under the PSA discussed above. PACA provides in relevant part:

Perishable agricultural commodities received by a commission merchant, dealer, or broker in all transactions, and all inventories of food or other products derived from perishable agricultural commodities, and any receivables or proceeds from the sale of such commodities or products, *shall be held by such commission merchant, dealer, or broker in trust for the benefit of all unpaid suppliers or sellers of such commodities or agents involved in the transaction, until full*

³⁴ 7 U.S.C. Section 196(b).

³⁵ 7 U.S.C. Section 196(c). Any such agreement to extend credit to buyer must be in writing and signed by the seller.

payment of the sums owing in connection with such transactions has been received by such unpaid suppliers, sellers, or agents. Payment shall not be considered to have been made if the supplier, seller, or agent receives a payment instrument which is dishonored. The provisions of this subsection shall not apply to transactions between a cooperative association, as defined in section 1141j(a) of title 12, and its members.³⁶

Similar to the PSA, under PACA, suppliers and sellers will lose the benefits of trust if they fail to give written notice of their intent to preserve the benefits of the trust to the commission merchant, dealer, or broker within thirty (30) days after expiration of the parties' payment terms. A supplier, (if the supplier is licensed under PACA) may also preserve the benefit of the trust and provide notice to the buyers by including on the face of its invoice the following **“The perishable agricultural commodities listed on this invoice are sold subject to the statutory trust authorized by section 5(c) of the Perishable Agricultural Commodities Act, 1930 (7 U.S.C. 499e(c)). The seller of these commodities retains a trust claim over these commodities, all inventories of food or other products derived from these commodities, and any receivables or proceeds from the sale of these commodities until full payment is received.”** No language other than this will be acceptable as complying with the statutory requirements.

Pursuant to PACA, the trust assets are created in the perishable agricultural commodities, the food related inventories or other products derived from the produce, and in any receivables or proceeds derived from the sale of such commodities or products. If non-PACA trust assets and PACA trust assets are or appear to be commingled, the buyer has the burden of establishing which assets, if any, are not subject to the PACA trust. The PACA beneficiary (i.e. the supplier or seller) has the burden of proving the amount of its claim.

³⁶ 7 U.S.C. § 499e(c)(2)

Just as with the trust provision under the PSA, because the buyer holds the PACA-trust assets for the benefit of the seller or supplier, in the event the buyer files for bankruptcy, the PACA-trust assets do not become “property of the estate” pursuant to Bankruptcy Code § 541. This allows the seller or supplier to obtain priority status over all other creditors with respect to the PACA-trust assets.

In *Nickey Gregory Company v. AgriCap, LLC*, 597 F.3d 591(4th Cir. 2010), producers sold produce to a debtor on credit. A finance company provided secured financing to the debtor for its working capital and the debtor granted a security interest in its accounts to secure such indebtedness. The debtor filed a Chapter 7 bankruptcy petition. The producers that sold produce to the debtor sought disgorgement from the finance company of assets in a sufficient amount to pay the producers as unpaid sellers of perishable agricultural commodities. The producers contended that the account receivables the finance company received from the debtor were trust assets under PACA. The finance company argued that its relationship with the debtor was not a creditor/debtor relationship. Instead, the finance company argued, it was a factoring agreement and thus it held no assets subject to a PACA trust. The finance company also argued that it was a bona fide purchaser for value. The court disagreed with the finance company and held that the account receivables were held as collateral for a loan, and thus were subject to a PACA trust. The court considered it important that the risk of non-collection remained with the debtor and therefore the parties had a creditor/debtor relationship. The PACA funds remained the property of the debtor and the claims of the producer were entitled to priority over that of the Article 9 secured creditor.

III. DOWN FOR THE COUNT: THE EASTERN LIVESTOCK BANKRUPTCY BATTLE

A. The Scene

Eastern Livestock Co., LLC (“**Eastern**”) is one of the (if not the) largest cattle brokerage companies in the USA. In early November 2010, Eastern wrote countless checks to producers to pay for livestock “purchased” by Eastern. On Tuesday, November 9, 2010, Fifth Third Bank, Eastern’s largest secured creditor, filed a civil lawsuit in Hamilton County, Ohio, seeking the appointment of a receiver of Eastern’s assets and it froze Eastern’s bank accounts. The court, in this receivership proceeding, appointed Elizabeth M. Lynch as the receiver of Eastern’s assets.

Upon commencement of the receivership proceeding, livestock markets, cattle producers/sellers, cattle trucking companies, and many others in the cattle industry who were doing business with Eastern were immediately in a jam as they were left unpaid and holding either bad checks or cattle. Fearing the Ohio action was only protecting Fifth Third Bank’s interest, three of Eastern’s creditors on December 6, 2010 filed an involuntary Chapter 11 bankruptcy proceeding placing Eastern in bankruptcy. The claims against Eastern reportedly exceeded \$94 million. Eastern had in place Packers and Stockyards Act bonds amounting to \$875,000 to cover its dealer activities as a registrant under the Packers and Stockyards Act – claimants holding claims against the Packers and Stockyards Act bonds, when and if they are paid will be paid only pennies on the dollar. In the free-for-all following the latest cattle industry Black Tuesday, numerous companies owing Eastern money began filing interpleader actions in various state courts throughout the cattle feeding belt, to ensure they paid the proper party and would not be subject to double liability. The widespread effect of the fall of such a large player in the cattle industry has led to several lawsuits, federal investigations and sparked debate over the necessity of legislation to protect those affected and to prevent a similar occurrence in the future.

B. Introducing the Players

1. *Eastern Livestock Co., LLC* is one of the largest cattle brokerage companies in the United States. Eastern, based out of New Albany, Indiana, began in the 1950s when Thomas “Tommy” Gibson began buying and selling cattle with his grandfather. John Gibson, Tommy’s brother, joined the company and they began expanding business over the next few decades. Eastern expanded to have branches in eleven states. The company purchases cattle at auction and then sells the cattle to feed lots (or sometimes places the cattle in feed lots for its account) where the cattle are fed and are prepared for slaughter. Eastern has been described as operating as a “market agency,” buying or selling livestock on commission, as a “dealer,” buying or selling livestock on its own account or as agent of the purchaser, and as “clearing agency,” providing back office services and bond coverage and being responsible for the payment obligations of others.

2. *The Gibson Family* founded Eastern and East-West Trucking Co., LLC. Tommy and his wife Patsy are also debtors in their bankruptcy proceeding. On January 20, 2011, the FBI seized \$4.7 million from Tommy and Patsy Gibson’s personal bank accounts.

3. *James A. Knauer* (“Trustee”) is the Bankruptcy Trustee for Eastern Livestock Co., LLC. He is a partner at Kroger Gardis & Regas in Indianapolis, Indiana. The Trustee established a blog with information about the bankruptcy and related cases available at <http://www.easternlivestockbkinfo.com>.

4. *Elizabeth M. Lynch, a Vice President at Developmental Specialists, Inc.*, was the receiver appointed in Fifth Third Bank’s Ohio state court action. She has now been retained by the Trustee as a consultant to assist the Trustee as he sifts through the various transactions.

C. **In the Right Corner**

1. ***Fifth Third Bank, N.A.*** is based out of Cincinnati, Ohio. Fifth Third Bank is Eastern's largest secured creditor. Fifth Third Bank has a claim against Eastern for \$35 million under its promissory note. Fifth Third Bank alleges its losses were caused by Eastern's "check kiting scheme."

2. ***First Bank and Trust Company*** is based out of Abington, Virginia, and was the major secured lender to Tommy and Patsy Gibson individually. Its loans are secured by security interests against all of Tommy and Patsy Gibson's cattle. First Bank is owed over \$8,000,000.

D. **In the Left Corner**

1. ***Superior Livestock Auction, Inc.*** ("**Superior**"), a Nevada corporation based out of Brush, Colorado, markets load-lots of cattle via satellite and via the internet. Superior has a claim against Eastern for \$13 million for cattle it sold to Eastern. Superior is involved in multiple adversary proceedings to determine its rights to certain interpled funds and to determine the validity and extent of contract assignments received from Eastern on November 8, 2010.

2. ***Friona Industries, L.P.*** ("**Friona**") is a Delaware limited partnership based out of Amarillo, Texas. Friona is the fourth largest capacity feed yard operation in the United States. It initiated the Texas interpleader action in U.S. District Court in Amarillo, Texas. Though a buyer and owing money for cattle purchases, it also has a claim for breach of contract and to recover down payments on future cattle sales that Eastern could not perform for \$915,444.47.

3. *Cactus Growers, Inc.* (“Cactus”), a Texas corporation based out of Amarillo, Texas, is the second largest capacity feed yard operation in the United States. It intervened in the Texas interpleader action that Friona began. Similar to Friona, it is a significant buyer of cattle from Eastern and it owes money to Eastern for cattle purchases but it also alleges to have a claim against Eastern to recover \$741,053.22.

4. *J & F Oklahoma Holdings, Inc.* (“J & F”) is a Delaware corporation doing business in Northern Texas, is a subsidiary of JBS (a Brazilian entity), and is the largest capacity feedyard operation in the United States. J & F also intervened in the Texas interpleader action. Similar to Friona, it owes money to Eastern for cattle purchases and also alleges to have a claim against Eastern to recover \$426,791.87.

5. *The Producers* who are comprised of hundreds of unpaid producers who sold cattle to Eastern and received bad checks or no checks – the Producers hold claims from a few thousand dollars to hundreds of thousands of dollars. Also included among the Producers are unpaid truckers who hauled cattle for Eastern and did not get paid. Early in this debacle, it was estimated that the Producers’ claims were somewhere between \$90 and \$130 million. However, as of the date of the claim bar date, there was only approximately \$40 million in proofs of claims filed by the Producers.

E. **The Undercards**

1. *Fifth Third Bank State Action*: On Tuesday November 9, 2010, Fifth Third Bank, Eastern’s largest secured creditor, filed a civil lawsuit in Hamilton County, Ohio, freezing Eastern’s assets and seeking the appointment of a receiver. The complaint alleged that Eastern had been sending approximately \$20 million back and forth daily between its operating accounts and an account that Tommy Gibson maintained at Your Community Bank in New

Albany, Indiana to manipulate the communications lag between financial institutions in order to create artificial balance (in other words, to create a “float”) from which Eastern could withdraw funds. The court appointed Elizabeth M. Lynch as receiver. This action was not stayed because Fifth Third Bank dismissed the bankrupt parties and is pursuing many Eastern employees for their actions as well as additional defendants Fifth Third Bank believes received the alleged converted funds.

2. ***Thomas and Patsy Gibson Bankruptcy:*** On December 1, 2010, Tommy Gibson and his wife Patsy filed Chapter 7 bankruptcy in the Southern District of Indiana, New Albany Division. Notably in this case, the Trustee has filed a \$1.3 billion claim for a promissory note and for alleged preferential and/or fraudulent transfers.

3. ***East-West Trucking Co., LLC Bankruptcy:*** East-West Trucking Co., LLC, based out of Indiana, is solely owned by Tommy Gibson and was founded in December 2005. On November 23, 2010, East-West Trucking filed Chapter 7 bankruptcy in the Southern District of Indiana, New Albany Division.

4. ***Superior Livestock Auction, Inc. v. Eastern Livestock Co., LLC:*** In April 2011, Superior filed an adversary proceeding to determine, among other things, whether Superior had rights to the funds interpleaded in the Texas interpleader action and what effect a pre-petition assignment between the parties had on Superior’s rights.

F. The Eastern Bankruptcy Adversary Proceedings

1. Interpleader actions:

i. ***Texas:*** On November 11, 2010, Friona filed an interpleader action in U.S. District Court for the Northern District of Texas, Amarillo Division. Friona had two types of agreements with Eastern. First, Friona received cattle from Eastern for which it had yet

to pay, totaling \$2,542,846.79. Second, Friona had paid to Eastern down payments of \$30 per head for Eastern's future delivery to Friona of cattle, which Eastern is now unable to perform. Friona alleges it paid Eastern \$627,780.00 of down money. In addition, Friona alleges damages in the amount of \$147,000.00 based on Eastern's inability to perform under the future delivery contracts. Cactus intervened in this action. The relationship between Cactus and Eastern is similar to the relationship existing between Eastern and Friona. Cactus interpleaded \$1,767,599.37 and it alleges it paid Eastern \$283,080.00 down money for Eastern's future delivery of cattle, which Eastern is now unable to perform. Cactus also alleges damages in the amount of \$360,000.00 based on Eastern's inability to perform under the future delivery contracts. J & F also intervened in this action. J & F's relationship with Eastern is similar to the relationship between Eastern and Friona. J & F interpleaded \$2,560,839.06 and it alleges it paid Eastern \$236,070.00 down money for Eastern's future delivery of cattle, which Eastern is now unable to perform. J & F also alleges damages in the amount of \$93,407.08 based on Eastern's inability to perform under the future delivery contracts. The opposition by Friona, Cactus, and J & F to any initial bankruptcy order affecting their rights in the Texas interpleader resulted in orders that excepted out any issues relating to the Texas interpleader so that their rights were not affected. Now, their fight will occur in this adversary proceeding for the money they paid down for future agreements and losses for the breach of those agreements.

ii. **Kansas: Innovative Livestock Services, Inc.** ("Innovative"), a Kansas Corporation, is a united group of feedyards with its principal offices in Great Bend, Kansas. On November 16, 2010, Innovative and BMG Natural, LLC ("BMG") filed an interpleader action in the District Court for Pawnee County, Kansas. During the first week of November 2010, BMG had acquired 1638 head of cattle from Eastern for a price of

\$1,110,533.44 and Innovative had acquired 571 head of cattle with a total price of \$395,347.08. Innovative and BMG interpleaded the monies they held that were payable to Eastern because of the various conflicting demands following Black Tuesday. Superior appeared in this interpleader suit claiming its right to \$742,905.86 of the interpleaded monies and alleging unjust enrichment against First Third Bank.

iii. Wisconsin: Rush Creek Ranch, LLP is a Colorado limited liability limited partnership engaged in the purchasing, feeding, stocking and selling feed cattle. On October 16, 2010 it filed an interpleader action in the Circuit Court for Vernon County, Wisconsin for money it owed to Eastern for cattle purchases. The amount of this interpleaded fund is a mere \$178,233.29.

iv. Colorado: Fredin Brothers, Inc. filed an action in the District Court, Prowers County, Colorado, and interpleaded \$423,184.07, the amount it claims to owe Eastern for cattle purchases.

2. Willie Downs: Willie Downs was the Branch Manager of Eastern's Branch 15 in Lexington, Kentucky. The Trustee sued Downs for fraudulent transfer, preferential transfer, turnover and conversion. He alleged that \$1,243,611.71 in endorsed checks belonging to Eastern that allegedly were fraudulently transferred to Downs.

3. Robert & Jane Nichols d/b/a Nichols Livestock v. Cactus Growers, Inc.: Despite the Texas interpleader action involving Cactus, Robert and Jane Nichols sued Cactus for \$112,609.17 in Kiowa County, Oklahoma. Nichols Livestock claims the cattle it sold to Eastern were delivered to a feedlot facility operated by Cactus. This action has been stayed pursuant to 11 U.S.C. §362.

4. **Atkinson Livestock Market, LLC: *Atkinson Livestock Market, LLC***

(“**Atkinson**”) is an Illinois limited liability company that purchased livestock from Eastern. The Trustee filed suit against Atkinson for \$2,577,880.13 for cattle Atkinson had allegedly purchased from Eastern.

G. **The Main Event: *Eastern Livestock Co., LLC Bankruptcy***

1. **Fifth Third Bank v. Everyone Else:** Fifth Third Bank is Eastern’s largest creditor. Fifth Third Bank holds a claim of approximately \$35 million and a blanket lien against essentially all of Eastern’s assets. A few theories have been asserted to defeat Fifth Third Bank’s interest:

(i) Equitable subordination: Wrong doing on the part of Fifth Third Bank should subordinate its claims to the claims of other creditors.

(ii) No title: Parties contend that Eastern never obtained title to certain cattle, and consequently Fifth Third Bank’s security interest never attached to the cattle or to the proceeds from the sale of those cattle.

2. **Notable Orders:**

i. *The Use of Cash Collateral and Financing.* On February 11, 2011, the Chapter 11 Trustee filed a motion seeking, among other things, authority to use up to \$2,000,000.00 of Fifth Third Bank’s cash collateral and to obtain additional financing from Fifth Third Bank in the amount of \$2,000,000.00. This additional financing from Fifth Third Bank was, according to the Trustee, needed to fund the Trustee’s various administrative and operating costs, including professional fees and expenses. In exchange for this \$4,000,000.00, the Trustee will: (a) pay to Fifth Third Bank any “excess cash collateral” free and clear of any claim or interest by any other party, (b) grant to Fifth Third Bank a priority administrative expense claim, liens and security interest in and against Chapter 5 Actions, (c) stipulate to the allowance of First Third Bank’s pre-petition secured claim, (d) provide to Fifth Third Bank budget information and

the opportunity to object to the Trustee's actions, (e) waive any claim of surcharge against Fifth Third Bank or its collateral and (f) waive the right to contest the validity, perfection, or amount of Fifth Third Bank's liens and claims. Not a bad deal for Fifth Third Bank.

Many parties in interest objected to this motion claiming, among other things, that bankruptcy law did not support such a transaction, that it was premature to waive claims against Fifth Third Bank, that allowing Fifth Third Bank priority against the Chapter 5 claims would consume the only amounts available to unsecured creditors, and that such a transaction made unsupported factual conclusions.

On March 18, 2011, despite objections, the court entered the Financing Order (I) Approving Chapter 11 Trustee Financing; (II) Authorizing the Use of Cash Collateral and Obtaining Credit Pursuant to Sections 361, 363, and 364 of the Bankruptcy Code; (III) Modifying the Automatic Stay; (IV) Providing Adequate Protection; and (V) Sealing Certain Documents, which approved the Trustee's Motion.

ii. *Purchase Money Claims.* After his appointment, the Trustee learned that many of Eastern's cattle buyers had not paid Eastern or the Trustee due to concern that third parties might assert liens or claims against the cattle or sale proceeds under Section 196 of the Packers and Stockyards Act (7 U.S.C. §§ 181 *et seq.*) or applicable state laws.

On January 6, 2011, the Trustee filed its Emergency Motion Regarding Payments on Debtors Cattle Sales. This motion sought an order authorizing the Trustee to collect outstanding sale receivables and hold the proceeds pending the resolution of lien or claims to specific proceeds.

Despite objections that the motion lacked specificity, created substantial professional fees further harming cattle sellers and created duplicative procedures which would otherwise be

handled in the interpleader actions, the bankruptcy court on January 24, 2011, issued its order granting the Trustee's Motion Regarding Payments on Debtor's Cattle Sales. The bankruptcy court authorized the Trustee to accept payment of "purchase money" and established an account and detailed procedures for filing a Purchase Money Claim with the Trustee. The bankruptcy court also provided indemnification to all cattle buyers making payment of purchase money to the Trustee.

On May 23, 2011, The Trustee filed its Motion to Transfer Funds and Notice of Release of Proceeds from Account. In the motion, the Trustee requested authority to transfer \$7,256,488.59 from the holding account established pursuant to the January 24, 2011 Order to its general operating account and in connection with that motion the Trustee alleged that First Third Bank was the only party holding a valid lien against the funds.

On July 1, 2011, the court issued its First Order Regarding the Trustee's Purchase Money Claims Report authorizing the transfer of \$1,603,287.69 from an escrow account to the general operating account, subject to objections. The Trustee could not transfer any portion of the funds having a proper and timely filed objection. The court is set to address the objections at a hearing following submission of this paper.

H. Legislative Responses to Eastern Livestock

1. Oklahoma. Oklahoma has enacted the "Livestock Owner's Lien Act of 2011," which will be codified in §§ 201.1-.11 of Title 4 of the Oklahoma statutes and will be effective on November 1, 2011. The statute is clearly designed to address some of the issues raised by the Eastern Livestock Co. bankruptcy.

Under the statute, a "livestock owner" will be entitled to assert a statutory lien in "all livestock sold" by the livestock owner for the unpaid portion of the sales price of such livestock.

The “owner’s lien” continues in the livestock after the sale by the owner and in all “proceeds.” “Proceeds is defined to include cash, accounts, chattel paper, instruments, payment intangibles and “by-products” derived from the slaughter of the livestock. The lien continues until the owner has received the full purchase price regardless of whether the “first purchaser” subsequently resells the livestock (or, presumably, the “by-products” of such livestock). The statutory lien is perfected automatically without the necessity of filing a financing statement. The owner’s lien “takes priority over any other lien, whether arising by contract, law, equity or otherwise.” The lien rights granted by the statute may not be waived, relinquished or released other than upon payment in full of the purchase price or unless the first purchaser provides for a letter of credit or escrow for payment of the purchase price.

The lien is available only to livestock owners. Under the statute, a “livestock owner” means a “person owning an interest in livestock before the acquisition thereof by a first purchaser.” A “first purchaser” means the first person to purchase livestock. If the owner’s livestock are commingled with other livestock so as to make it impossible to identify the owner’s livestock, then the lien attaches to the commingled livestock , but only as to the percentage of the commingled livestock equal to the number of livestock to which the owner’s lien attached. A livestock purchaser or “sales agent” takes free of an owner’s lien if the full amount of the purchase price is paid to the owner or sales agent. The owner’s lien will “transfer” to the proceeds paid by the purchaser to sales agent. The owner’s lien has priority over the rights of any purchaser or sales agent. The owner’s lien will continue in proceeds paid by a first purchaser at least until they are no longer identifiable actually or by tracing rules. An owner’s lien will expire one year after the last day of the month following the date the sales price was to be paid, unless an action to enforce the owner’s lien is commenced within such time. If a sales

agent advances the sales price for livestock before the first purchaser pays the sales price to the agent, the agent shall be entitled to enforce all rights of the livestock owner.

It is obvious the statute is intended to provide automatic protection for unpaid sellers of livestock without any need to provide notice to competing secured parties or other purchasers down the line, at least so far as the livestock can be identified in their possession, the necessity for perfection of the statutory lien, etc. However, the statute goes well beyond its federal counterpart, the packer trust established under the Packers & Stockyards Act (“PSA”). The owner’s lien provided by the statute is much broader than the packer trust provided by the PSA in at least two significant respects:

(i) The statute is not limited to cash sellers. Thus, if a livestock owner agrees to sell livestock on credit, it will be entitled to the protections of the statute even if it made a poor credit decision.

(ii) The statute is not limited to packers since market agencies, dealers and stockyards will also be subject to the lien. The packer trust provided by the PSA is applicable only to packers.

The definition of “livestock owner” is curious and may actually limit the applicability of this statute (and effectiveness in protecting livestock sellers) significantly. It would appear the definition would *exclude* any owner of livestock which was purchased from a third party. For example, if a cattle stocker acquired calves, the stocker would appear to be a “first purchaser” under the statute. As a result, the stocker would *not* be a “livestock owner.” As such, it may not be entitled to the owner’s lien provided by the statute upon a subsequent sale to a feedyard or packer.³⁷

³⁷ It could be argued that, following the purchase of calves by a stocker, the calves are no longer the same “livestock” that was sold by the cow-calf operator, but that approach is not found in the statute. Another argument is you do not focus on the past. Thus, the stocker would be considered a livestock owner and the feedyard or packer would be the first purchaser.

The statute will likely conflict head-on with Article 9 of the UCC when the “first purchaser” is located in a state other than Oklahoma. And, based upon the case law located at this time, it will probably be ineffective for the livestock owner. Under UCC § 9-301, the law of the location of the debtor determines the priority of a security interest. If the first purchaser is located outside Oklahoma, and has granted a security interest in its inventory to secured lender, the law of the state of the debtor’s location will govern the priority of the lender’s security interest.³⁸ And, because the Oklahoma livestock owner will not have perfected in that state, the owner will likely lose to the lender.

This is the teaching of *In re SemCrude, L.P.*, 407 B.R. 82 (Bankr. D. Del. 2009) which carefully considered the perfection and priority issues raised by KSA § 84-9-339(a), a statute very similar to the Oklahoma statute. KSA§ 9-339(a) is a special non-uniform provisions that deal with security interests with respect to the production of oil and gas and the sale of oil and gas. On date that SemGroup and its subsidiary filed bankruptcy, it had already received the oil and gas from certain producers of crude oil and natural gas in Kansas but had yet to pay them for it. Kansas producers sought declaratory relief to establish their rights, status and priority regarding crude oil and natural gas sales to the debtors. However, as of the petition date, certain banks asserted a security interest in substantially all of the debtors’ assets. The bankruptcy court concluded that KSA§ 9-339(a) did not apply, and Delaware's version of the UCC did not contain Kansas' special provision for producers of oil and gas. According to the court, the law of the places in which the debtors resided applied, and the Kansas producers needed to file UCC financing statements in either Delaware or Oklahoma (the residence of the debtors) to perfect their security interests in the production sold.

³⁸ UCC § 9-322(g) will have no application to consideration of the priority of the livestock owner’s lien since it may not meet the definition of an “agricultural lien” under UCC § 9-102(a)(5).

The lack of a perfection requirement makes this lien a “secret lien,” the scope of which no competing lender can determine until after a livestock buyer fails. Since the lien will continue following the resale of the livestock or livestock by-products, subsequent purchasers of livestock and livestock products will be exposed to lien claims from remote livestock sellers with whom they have not done business based upon secret liens which cannot be discovered. Of course, for people in the industry there should be an awareness of the lien, and thus the ability to take protective steps. The only express limitation on this exposure is that the lien “expire[s]” one year after the last day of the month following the date the purchase price is to be paid.

The priority provisions of the statute would appear to provide the owner’s lien will have priority over any competing liens, including state tax liens, judgment liens, security interests, mortgages, etc. Any liens provided by federal law (e.g., federal tax liens) will continue to be governed by federal law. Thus, in the case of a defaulting packer subject to the statute, there could well be a priority fight between Oklahoma livestock owners and unpaid cash sellers from other states who rely upon the packer trust provisions of the PSA. There also could be conflicts with other statutory liens such as for storage, transportation, feeding and so on. Whether a court will uphold the expressed priority is open to some question.

While the rights under the statute may not be waived, nothing in the statute expressly precludes a livestock owner from subordinating its rights, including lien rights, although a court may well consider subordination to be a waiver.

The only express remedy provided by the statute is the foreclosure of the lien by the commencement of an action in court. If the goal of the legislation is to protect livestock sellers, a judicial remedy is not the most cost effective or expeditious remedy. One wonders whether other law, such as replevin, is displaced.

Whether the Oklahoma legislation will achieve its goals is open to question for several reasons:

(i) The concept of “first purchaser” may not provide the desired results in the livestock industry due to the multiple transactions typically involved in moving livestock through the production system. In both the beef and pork industries, young animals (i.e., calves and feeder pigs) are often bred and sold to livestock producers which then raise the animals to slaughter weight.

(ii) The choice of law problems render a state law “fix” to the issues presented by *Eastern Livestock* problematic unless a uniform law is widely enacted. It may provide limited protection for Oklahoma livestock producers who sell to a “first purchaser” located in Oklahoma. However, as noted above, the statute may do little to protect livestock owners who sell livestock to “first purchasers” outside Oklahoma.

2. Kentucky. The Kentucky legislature has also taken steps in reaction to *Eastern Livestock*. Bills were introduced to prevent a reoccurrence of *Eastern Livestock*. Three bills that were introduced were referred to as the “Livestock Marketing Integrity Legislation.” Two of the bills, House Bills 92 and 94, would have added language requiring buying stations to be treated more like how stockyards are treated. The legislation would require buying stations to be licensed and to file monthly reports of the number of livestock received and sold. Buying stations or livestock dealers that are required to be bonded by the federal government would be required to file an irrevocable bank letter of credit with the Kentucky Department of Agriculture. The definition of a buying station is “as a private livestock market that offers stockyard services.” These are not regulated under the federal Packers and Stockyards Act. The bills also provide separate definitions of a livestock dealer and a farmer. In addition, stockyards would be required to identify all dealers conducting business with them and to verify that such dealers are properly licensed and bonded.

The bills also establish a livestock seller’s lien which would come into play if a seller does not receive payment within three business days of the delivery of livestock. The lien may be on the livestock itself, cash from the sale of livestock, or any property of the buyer that may

be subject to a security interest. The lien would be effective the day the livestock is delivered to the buyer and perfected upon the seller filing a financing statement with the Kentucky Secretary of State. The bills also would expand the penalties for violating any provision of the chapter. For example, the Commissioner of Agriculture would be able to issue a stop movement order on livestock for a violation and each head of livestock not paid for would be treated as a separate offense. Time ran out for the legislature before these two bills were passed.

The Oklahoma and Kentucky legislative efforts are likely to be the first of many in light of the significant losses likely to be sustained by livestock producers in the Eastern Livestock case. It is also anticipated that livestock interests will also seek Congressional relief when the 2012 farm bill process is launched.

Discharging Tax in Chapter 12: The Supreme Court Takes Up § 1222(a)(2)(A)

Background

On June 13, 2011 the United States Supreme Court granted certiorari in United States v. Hall, 617 F.3d 1161 (9th Cir. 2010), cert. granted (No. 875, 2010 Term.). At issue is the meaning of Section 1222(a)(2)(A) of the Bankruptcy Code, enacted in 2005 as part of the Bankruptcy Abuse Prevention and Consumer Protection Act (“BAPCPA”). Section 1222(a)(2)(A), which took effect on April 20, 2005, appears to afford a Chapter 12 debtor the power to strip tax claims of priority status and to treat them as general unsecured claims.

Section 1222 in general governs the contents of a Chapter 12 plan. Among other things, it requires full payment of claims entitled to priority under Section 507. Section 1222(a)(2)(A) creates an exception to this requirement for a claim “owed to a governmental unit that arises as the result of the sale, transfer, exchange, or other disposition of any farm asset used in the debtor’s farming operation.” Such a claim “shall be treated as an unsecured claim that is not entitled to priority under section 507, but the debt shall be treated in such manner only if the debtor receives a discharge.”¹

Three principal questions have arisen and been litigated concerning the meaning and application of Section 1222(a)(2)(A).² Does the Section apply only to capital gain tax?³ Assuming the application of § 1222(a)(2)(A), what is the proper allocation of taxes entitled to priority and non-priority treatment? Does § 1222(a)(2)(A) apply to tax that arises post-petition, or only to pre-petition tax? It is in answering this final question that a split of authority has occurred. The Eighth Circuit holds that § 1222(a)(2)(A) does apply to both pre-petition and post-petition taxes; the Ninth Circuit and Tenth Circuit hold that § 1222(a)(2)(A) does not apply to post-petition taxes.

Section 1222(a)(2)(A) applies only to “claims entitled to priority under 507.”⁴ Section 507 includes only two categories of taxes that are entitled to priority treatment: 1) pre-petition taxes allowed under § 507(a)(8), and 2) post-petition taxes that qualify under § 507(a)(2). Section 507(a)(2) accords priority to “administrative expenses allowed under § 503(b).” Section 503(b)(1)(B)(i) in turn allows an administrative expense for “any tax...incurred by the estate.”⁵ The circuits essentially disagree over the meaning and significance of the phrase “incurred by the estate” as it appears in § 503(b)(1)(B)(i). The

¹ § 1222 does not specify that the discharge occur under § 1228. An issue which has not yet found its way into court is whether or not in a discharge under § 727 (in a post-confirmation conversion of a Chapter 12 to Chapter 7) the tax liability would retain its unsecured, nonpriority status and so be discharged. Does the priority stripping power of 1222 survive conversion and carryover into the 727 discharge?

² This discussion focuses primarily on the issue that has been taken up to the Supreme Court. The other issues are only briefly discussed.

³ This question was not addressed in *United States v. Hall*, but rather in *Knudsen v. IRS*, 581 F.3d 696 (8th Cir. 2009). The 8th Circuit case decided that §1222(a)(2)(A) is not restricted to capital gain tax. See discussion below.

⁴ 11 U.S.C. § 507. Priorities.

⁵ 11 U.S.C. § 503(b)(1)(B)(i). Section 503, Allowance of Administrative Expenses.

Ninth Circuit and Tenth Circuit interpret the phrase to require the existence of a taxable entity legally capable of incurring liability for a tax. They find, principally in reliance on the Internal Revenue Code, 26 U.S.C. §§ 1338 and 1339, that a Chapter 12 estate cannot incur tax. In that the Chapter 12 estate cannot incur liability for a tax, any tax that arises post-petition is not a priority administrative expense and therefore not subject to treatment under § 1222(a)(2)(A). The Eighth Circuit interprets the phrase “incurred by the estate” to mean incurred post-petition and, in reliance primarily on the intent of the statute as determined from its language and from legislative history, declines to interpret the phrase in the context of the Internal Revenue Code.

The Supreme Court has framed the question presented as follows:

After filing a Chapter 12 bankruptcy petition, Petitioners sold their family farm with the consent of their bankruptcy trustee and court approval, and with sale proceeds administered through the bankruptcy estate to pay creditors. Internal Revenue Code § 1399 provides that a bankruptcy filing other than an individual Chapter 7 or individual Chapter 11 does not give rise to a "separate taxable entity." Does that IRC provision mean that the capital gains income tax incurred due to the sale of the farm is not a Bankruptcy Code administrative expense owed by the bankruptcy estate and payable under a bankruptcy reorganization plan? If so, Bankruptcy Code § 1222(a)(2), enacted to provide special treatment of such family farmer administrative expenses, would not apply or permit Petitioners to satisfy the tax as an unsecured claim that is not required to be paid in full.

6

The Cases

KNUDSEN and SCHILKE – 8TH CIRCUIT

The first appellate decision on § 1222(a)(2)(A) was handed down by the Eighth Circuit in Knudsen v. IRS, 581 F.3d 696 (8th Cir. 2009). This decision came in the consolidated appeals of an Iowa case, *In re Knudsen*,⁷ and a Nebraska case, *In re Schilke*.⁸

The debtor in *Knudsen* had sought § 1222(a)(2)(A) treatment for the tax liability arising out of the pre-petition liquidation of its swine herd, including the sale of both breeding livestock (sows and boars) and market livestock (slaughter hogs). The debtor also sought § 1222(a)(2)(A) treatment for the post-petition sale of machinery and real estate. The appeal in *Knudsen* involved three principal issues: 1) Should § 1222(a)(2)(A) treatment be limited to capital gain liability? 2) How should the § 1222(a)(2)(A) treatment be allocated against taxes, and 3) Is § 1222(a)(2)(A) applicable to post-petition claims?

⁶ <http://www.supremecourt.gov/Search.aspx?FileName=/docketfiles/10-875.htm>.

⁷ 356 B.R. 480 (Bankr. N.D. Iowa 2006).

⁸ 379 B.R. 899 (Bankr. D. Neb. 2007).

In *Schilke*, the debtor sold real estate and breeding livestock post-petition pursuant to an approved motion to sell and then provided in the Chapter 12 plan that the liability incurred through those sales would be treated under § 1222(a)(2)(A) as a general unsecured claim subject to discharge. The *Schilke* appeal involved the application of § 1222(a)(2)(A) to post-petition claims.

The Capital Gain Issue

In *Knudsen*, the IRS argued that market hogs, as opposed to the breeding livestock, or sows and boars, were not *used* in the debtor’s farm business but were the products of that business. The IRS argued that the § 1222(a)(2)(A) phrase “used in the debtor’s farming operation” should have the same meaning as the phrase “property used in a trade or business” as found in the Internal Revenue Code, 26 U.S.C. § 1231(b)(3). In other words, that § 1222(a)(2)(A) should be limited to treatment of capital gain tax. The IRS prevailed on this issue in the bankruptcy court but lost in the district court. The Eighth Circuit agreed⁹ with the district court and reversed the bankruptcy court’s judgment that the slaughter hogs were not a “farm asset used in the debtor’s farming operation.”¹⁰

The Method of Allocation

Assuming § 1222(a)(2)(A) applies to a tax claim, the question arises as to the proper allocation of that treatment in the return. To simplify, the IRS argued for use of the “proration or proportional method” under which the tax owing would be reduced by the percentage of income attributable to sales of § 1222(a)(2)(A) assets. The debtor argued for use of the “marginal method” under which all § 1222(a)(2)(A) qualifying income is removed from the return, in effect treating the qualifying income as the “last dollars in” and therefore subject to the highest marginal tax rate. The debtor’s method has the advantage to the debtor of potentially reducing the rate of tax on the non-qualifying income. The bankruptcy court had ruled against the debtor and ordered application of the proportional method. Both the district court and the Eighth Circuit reversed the bankruptcy court’s decision on use of the proportional method, citing policy reasons in the face of statutory silence.¹¹

The Post-Petition Taxes Issue

⁹ A dissenting opinion in the Eighth Circuit *Knudsen* decision rejected the extension of § 1222(a)(2)(A) treatment to tax arising from the disposition of non-capital gain assets.

¹⁰ Although considerable portions of both the Eighth Circuit and Iowa district court decisions dealt with this capital gain question, it is an issue that appears will not be taken up by the Supreme Court. However, the Eighth Circuit in *Knudsen* in part supported its decision rejecting the capital gain restriction by stating that: “§ 1222(a)(2)(a) is not a federal income tax provision found in the Bankruptcy Code; instead, it is a priority-stripping provision that applies to any tax claim—federal, state, or local. Therefore, we decline to apply the § 1231 of the IRC in the bankruptcy context and instead rely on the provisions of the Bankruptcy Code itself in interpreting § 1222(a)(2)(A).” The Supreme Court’s interpretation of the interplay between the IRC and the Bankruptcy Code could implicate this part of the *Knudsen* decision. This capital gain issue has also arisen and been decided in favor of the debtor in *In Matter of Uhrenholdt*, BK06-40787-TLS (Bankr.Neb. 1/26/2009), and *In re Ficken*, 430 B.R. 663 (10th Cir. BAP 2010).

¹¹ The issue of allocation has arisen in other cases, namely *In the Matter of Rickert*, BK06-40253-TLS (Bankr.Neb. 1/9/2009) (Bankr.Neb., 2009), and *In re Ficken*, *id.* In *Rickert*, decided before the Eighth Circuit *Knudsen* decision, the Nebraska bankruptcy court, like the bankruptcy court in *Knudsen*, preferred the proportional method.

The IRS made three arguments for the inapplicability of § 1222(a)(2)(A) to post-petition taxes. It argued that 1) a Chapter 12 Plan cannot bind holders of post-petition claims because they are not “creditors” within the meaning of 11 U.S.C. § 101(10)(A) and the plan can only bind creditors under § 1227;¹² 2) the government had not waived its sovereign immunity with respect to § 1222(a)(2)(A); and 3) income tax claims arising from the post-petition sale of assets do not constitute an “administrative expenses” under 11 U.S.C. § 503(b)(1)(B)(i).

The Iowa bankruptcy court found that taxes incurred post-petition by individual debtors can be administrative expenses for purposes of payment under the plan. “In a bankruptcy case, the payment of a tax imposed against a debtor may still be ‘divided, into separate components in accordance with the bankruptcy laws determining the priority of payment of those claims,’” citing *Missouri Dept. of Revenue v. L.J. O’Neill Shoe Co. (In re L.J. O’Neill Shoe Co.)*, 64 F.3d 1146, 1152 (8th Cir. 1995).¹³ The court relied on *O’Neill Shoe* to find that “even though [the debtor’s] chapter 12 estate is not a separate taxable entity, [their] plan may provide for payment of taxes arising from income earned after the filing of the petition, and such taxes may be treated for distribution purposes as administrative expenses under 11 U.S.C. § 503(b)(1)(B).”

In June 2008, the district court for the northern district of Iowa affirmed *inter alia* the bankruptcy court’s ruling that § 1222(a)(2)(A) applies to post petition taxes.¹⁴ The court found that nothing in the plain language of § 1222(a)(2)(A) restricts its applicability to pre-petition sales (citing *Schilke*). The district court agreed with the IRS that the filing of a Chapter 12 does not establish the Chapter 12 estate as a separate taxable entity. However, the court stated, “that is not the end of the matter...the issue turns on the meaning of the terms in the Bankruptcy Code...and principles of bankruptcy law.” (*Knudsen*, 389 B.R. at 677.) The court went on to find that the meaning under §503(b)(1)(B) of the phrase “incurred by the estate” is ambiguous,¹⁵ and after a discussion of the legislative history of § 503(b), held that the phrase “incurred by the estate” refers to the *time* when the tax liability is incurred rather than to the existence of the estate as a taxable entity. (*Knudsen*, 389 B.R. at 680.) The court also discussed *O’Neill Shoe*’s support for this interpretation of the phrase “incurred by the estate.” In

¹² This issue also arose in Ninth Circuit decision in *Hall*.

¹³ *O’Neill Shoe* involved a Chapter 11 corporate debtor. Such a debtor is not deemed to be a taxable estate under IRC §§ 1338 and 1339. In trying to determine which claim at issue would be allowed as an administrative expense, *O’Neill Shoe* provides in relevant part as follows: “Under the terms of [11 U.S.C. Sec. 503(b)(1)(B)(i)], the tax claim must satisfy a “two-prong test” to qualify as an administrative expense claim. *City of New York, Dept. of Finance v. R.H. Macy & Co. (In re R.H. Macy & Co.)*, [176 B.R. 315, 316-17 \(S.D.N.Y.1994\)](#) (citing [In re O.P.M. Leasing Serv., Inc.](#), [68 B.R. 979, 982 \(Bankr.S.D.N.Y.1987\)](#)). First, the tax must be “incurred by the estate.” *Id.* Second, the tax must not be ‘specified in section 507(a)(7).’ *Id.* Section 507(a)(7) provides a seventh priority in distribution to certain types of tax claims. If either of these two requirements is not satisfied, then the claim is not entitled to administrative expense treatment. The bankruptcy court and the district court both held that while the entire corporate tax was “incurred by the estate” (i.e.--incurred postpetition), the portion of the tax attributable to prepetition income was “of a kind specified in section 507(a)(7).”

¹⁴ *In re Knudsen*, 389 B.R. 643 (N.D.Iowa 2008).

¹⁵ The district court cited *In re Dawes*, 382 B.R. 509 (Bankr. Kan. 2008), discussed *below*, in support of its holding that the phrase is ambiguous.

addition, the court stated that legislative history supports the application of § 1222(a)(2)(A) to post-petition taxes.¹⁶ Citing *Dawes* and *Schilke*, the court also found that to adopt the IRS interpretation would render the statute meaningless for most debtors as it would apply only to the farmers who had the foresight to liquidate assets before filing and would provide no benefit in a reorganization involving the sale of assets.¹⁷

In *Schilke*, the Nebraska bankruptcy court, finding that the intent of the statute is to help farmers reorganize, agreed with Knudsen that § 1222(a)(2)(A) ought to apply to post-petition taxes.

[T]he language of § 1222(a)(2)(A) indicates that it was intended to apply to taxes arising during the Chapter 12 proceeding. Specifically, it refers to ‘a claim owed to a governmental unit that *arises* as a result of the sale, transfer, exchange, or other disposition of any farm asset used in the debtor’s farming operation....’ (Emphasis added.) To interpret § 1222(a)(2)(A) as being inapplicable to taxes arising post-petition is effectively adding language to the statute that simply is not there.

Further even though a Chapter 12 bankruptcy estate is not a separate taxable entity, the estate does exist nonetheless. The estate consists of all property of the debtor on the date of filing, all property that the debtor acquires after commencement of the case, and all earnings from services performed by the debtor after commencement of the case. 11 U.S.C. § 1207(a). [] The taxes at issue are created by the sale of property of the estate by Debtor. I do not believe that the language of § 503(b)(1)(B) regarding any tax ‘incurred by the estate’ was intended to apply only to those situations where the estate itself is a separate taxable entity. In fact, ‘incurred by the estate’ has been interpreted to simply mean incurred post-petition. *L.J. O’Neill Shoe Co.*, 64 F.3d at 1149 (stating “[t]he bankruptcy court and the district court both held that while the entire corporate tax was ‘incurred by the estate’ (i.e. — incurred post-petition). ...”). Here, there clearly is an estate, the tax is the result of a sale of property of the estate, and Debtor happens to be liable for that tax.” (379 B.R. at 902-903.)

On appeal, the district court for Nebraska affirmed *Schilke*.¹⁸

The Eighth Circuit, on the issue of the applicability of § 1222(a)(2)(A) to post-petition taxes in the consolidated appeals for *Knudsen* and *Schilke*, affirmed the bankruptcy

¹⁶ 145 Cong. Rec. S570-02, S764, 1999 WL 20426 (Jan. 20, 1999), (statement of Senator Grassley on S.260). “Senator Grassley referred to the need to relieve family farmers seeking reorganization from the “crushing tax liability if they need to sell livestock or land in order to reorganize their business affairs” and from the need to pay the IRS in full “for any tax liabilities generated during a bankruptcy reorganization.” 389 B.R. at 676. Note that Senator Grassley made this statement approximately six years prior to enactment of § 1222(a)(2)(A). It occurred as part of a prior, failed effort to enact identical language into the bankruptcy code.

¹⁷ “In fact, if [§ 1222(a)(2)(A)] is inapplicable to post-petition taxes as the IRS suggests, the statute becomes meaningless for most debtors as it provides no benefit in a reorganization involving the sale of assets used in a farming operation. Chapter 12 expressly contemplates that a plan may provide for the sale of property of the estate. 11 U.S.C. § 1222(b)(8).” *Schilke*, 379 B.R. at 903.

¹⁸ *In re Schilke*, No. 4:07 CV 3283, 2008 U.S. Dist. LEXIS 68176 (D. Neb. Sept. 9, 2008).

courts. It supported its decision that § 1222(a)(2)(A) applies to post-petition taxes on several grounds. First, it found that nothing in the plain language of the statute restricts its application to pre-petition sales. Second, as supported by *O'Neill Shoe*, it found that “incurred by the estate” means incurred post-petition. Third, it rejected the IRS argument that for the tax to be “incurred by the estate” required the existence of a separate taxable entity. The court said: “[I]t is the IRC, not the Bankruptcy Code, that creates a ‘separate taxable entity’ upon the filing of petitions by individuals under Chapters 7 and 11 but does not create a separate taxable entity in cases filed by individual debtors under Chapters 12 and 13.” (581 F.3d at 709.) The court added that even though there is no separate taxable entity in Chapter 12 case, an “estate” still exists, pursuant to § 1207.¹⁹ Finally, the court noted that most cases which had considered the issue reached the same conclusion.²⁰

HALL – 9TH CIRCUIT

Certiorari has been granted in the appeal of the Ninth Circuit’s decision in United States v. Hall, 617 F.3d 1161 (9th Cir. 2010), cert. granted (No. 875, 2010 Term.).

In *Hall*,²¹ the debtors sold their 320 acre farm post-petition and moved to treat the \$29,000 capital gain arising from the sale as an unsecured claim under § 1222(a)(2)(A). The Arizona bankruptcy court found Knudsen’s reliance on *O'Neill Shoe* “misplaced.” According to the court, *O'Neill Shoe* did not answer the precise question at issue, which was “whether a Chapter 12 estate can incur a federal capital gains tax liability that arises post-petition.” (376 B.R. at 745.) *Hall* chose to follow *In re Brown*,²² a Chapter 13 case out of the Massachusetts bankruptcy court, in finding that § 503(b)(1)(B)(i) simply does not answer the question of what it means for a tax to be incurred by the estate. The *Hall* court agreed with *Brown* that “§ 503(b)(1)(B)(i) must be read in conjunction with 26 U.S.C. §§ 1398 and 1399 of the Internal Revenue Code.” (376 B.R. at 746.) *Hall* stated that in statutory interpretation the language of the statute is the starting point but that the language must be viewed in context, and the *Hall* court found that the context in deciding the § 1222(a)(2)(A) issue “includes the interplay between the Bankruptcy Code as amended by BAPCPA, and the Internal Revenue Code of 1986.” (376 B.R. at 746.) In support of this reliance on the Internal Revenue Code for its interpretation of § 1222, the *Hall* bankruptcy court quoted the maxim that courts are to “assume that Congress is

¹⁹ See *Schilke* supra at 902.

²⁰ Citing among others *W. Va. State Dep't of Tax & Revenue v. I.R.S. (In re Columbia Gas Transmission Corp.)*, 37 F.3d 982, 984 (3d Cir.1994), and *In re Northeastern Ohio Gen. Hosp. Ass'n*, 126 B.R. 513, 515 (Bankr.N.D. Ohio 1991). 581 F.3d at 709.

²¹ *In re Hall*, 376 B.R. 741 (Bankr. Ariz., 2007).

²² *In re Brown*, No. 05-41071, 2006 Bankr. LEXIS 3156 (Bankr. D. Mass. Nov. 20, 2006). In *Brown*, the Chapter 13 debtor sought to treat capital gain tax arising from the post-petition sale of his rental property as an administrative claim for which the estate was liable, and which would be paid under the Chapter 13 Plan. *Brown* argued that since the property that was sold was property of the bankruptcy estate when it was sold, the estate should be liable for payment. A creditor objected (though the trustee did not) arguing that under § 1305 a tax creditor may pursue payment directly from the debtor after the case is closed. The court found that the treatment of post-petition taxes as a priority claim under § 503(b)(1)(B)(i) does not apply in Chapter 13 cases because there is no taxable estate in Chapter 13 under 26 U.S.C. §§ 1338 and 1339.

aware of existing law when it passes legislation.” (376 B.R. at 746, citing Miles v. Apex Marine Corp., 498 U.S. 19 (1990).)

In August 2008, the federal district court for Arizona, in the debtor’s appeal from *Hall*, rejected the bankruptcy court’s decision.²³ The district court concurred with the application of *Knudsen* in *Dawes*²⁴ and it concurred with and adopted the *Schilke* analysis. Although it rejected the bankruptcy court’s critique of *O’Neil Shoe*, the court stated that “based on Congressional intent,” without reliance on *Knudsen* or *O’Neill*, it found that “Chapter 12 post-petition capital gains are administrative expenses” (393 B.R. at 862.) The court nonetheless found *O’Neill Shoe* to be supportive in that 1) allowance of administrative claims as entitled to priority is so well established that it does not matter that the administrative claim status was not litigated in *O’Neill*; 2) the post-*O’Neill* amendments to § 507 in BAPCPA related to eighth priority claims and were irrelevant; and 3) as in Chapter 12, there was no separate taxable estate created in *O’Neill Shoe*, a fact that supports reliance on *O’Neill* in the § 1222 context. The district court also questioned the bankruptcy court’s reliance on the Internal Revenue Code: “Although IRC §§ 1398 and 1399 were in place at the time of BAPCPA, this Court has been unable to find any Chapter 12, or even any Chapter 7 or Chapter 11 case, where those IRC provisions were held to be relevant to the construction of the definition of administrative claim in § 503(b)(2)(B)(i).” (393 B.R. at 863.) The court adopted *Schilke*’s reliance on Congressional intent and legislative history. Finally, the district court in *Hall* admonished the IRS that “§§ 1222, 507 and 503 are not federal income tax provisions found in the Bankruptcy Code [] but are properly understood as bankruptcy provisions to be construed in accordance with the Bankruptcy Code and bankruptcy policy to promote the effective reorganization of family farming operations.” (393 B.R. at 863.)

In reversing the district court and holding that § 1222(a)(2)(A) does not apply to post-petition taxes, the Ninth Circuit rejected the reasoning of the Eighth Circuit in *Knudsen*.²⁵ The Ninth Circuit essentially held that 1) “incurred by the estate” does not merely mean incurred post-petition because “although all taxes incurred by the estate are incurred post-petition, not all taxes incurred post-petition are incurred by the estate.” (617 F.3d at 1165);²⁶ 2) there is no authority for the proposition that a Chapter 12 bankruptcy estate

²³ *In re Hall*, 393 B.R. 857 (D. Ariz. 2008).

²⁴ 382 B.R. 509 (Bankr. Kan. 2008). See discussion below.

²⁵ *United States V. Hall*, 617 F.3d 1161 (9th Cir. 2010).

²⁶ In support of this view, the 9th circuit referenced two cases. (See Footnote 20 *supra*.) It is not clear how the 9th Circuit believes those cases support its position. Each of the cited cases, which were also cited by the 8th Circuit in *Knudsen* in support of its decision, seems more clearly to support the position that the critical issue in determining the meaning of “incurred by the estate” under § 503 is temporal – when did liability for the tax arise. In *Columbia Gas Transmission*, for example, a Chapter 11 case involving a corporate debtor (a debtor for which no taxable estate is created under the IRC § 1338), the court, in trying to decide what if any part of the corporate tax liability would be given priority status under § 503, stated:

Whether or not Columbia Gas is entitled to administrative expense priority for the property taxes depends on which date it “incurred” the property taxes under section 503(b)(1)(B). See 3 Collier on Bankruptcy, p 503.04, at 503-34 (15th ed. 1994) (“Whether a tax has been ‘incurred by the estate’ is not always easy to determine. The time of assessment or payment may not be equivalent to the time the tax is incurred for

has an inherent ability to incur taxes nor for the proposition that the Bankruptcy Code as a whole indicates that all estates regardless of chapter have the inherent ability to incur taxes. (617 F.3d at 1166); 3) reliance on IRC §§ 1338 and 1339 is justified because a) the United States Code must be read as a whole, and b) Congress has indicated repeatedly that it is aware that the taxable entity provisions in the IRC are relevant to the Bankruptcy Code; 4) it is irrelevant that the plain language of § 1222(a)(2)(A) does not restrict its application to pre-petition taxes because the cross references in § 1222(a)(2)(A) itself “clearly lead us to the provisions that restrict their reach;” and, 5) even though the court states its sympathy with the approach outline by Senator Grassley in legislative history, there is no need to refer to legislative history in the face of clear statutory language, and even if the court were to refer to legislative history it is unpersuasive both under § 503 and § 1222.²⁷ The court conceded that the drafter’s intention for § 1222(a)(2)(A) might differ from the text, but held that its “duty was to follow the text because the text is the law. Congress is entirely free to change the law by amending the text.” (617 F.3d at 1167.)

Circuit Judge Paez dissented from the majority in Hall. He found that Congress’s intent was clear and stated that he would follow *Knudsen*, which approach would “honor Congress’s clear intent and avoid an unwarranted circuit split.” (617 F.3d at 1168.)

DAWES – 10TH CIRCUIT

In *Dawes*,²⁸ after a prolonged history of litigation which included convictions for tax fraud, the debtors sought § 1222(a)(2)(A) treatment for the capital gain arising from the sale of real estate. The bankruptcy court explicitly found the phrase “incurred by the estate” as it appears in § 503 to be ambiguous. As the court stated: “‘Incurred by the estate’ could have reference to the time liability for a tax accrues — did the liability arise before or after the creation of the estate under § 541. Or, ‘incurred by the estate’ could have reference to the entity liable for the tax — is the bankruptcy estate created under § 541 liable for the tax? Accordingly, the Court will consider legislative history to

the purpose of establishing priority under section 503(b)(1)(B). Rather, the significant fact may be the date the tax accrues.”) If the property taxes were “incurred by the estate” of Columbia Gas on September 15, 1991, the date of the tentative assessment, *the property taxes must be given priority as an administrative expense under section 503*. If, however, before Columbia Gas filed its bankruptcy petition the property taxes were incurred in 1990, the period covered by its May 1, 1991 tax return, the property taxes would not be entitled to administrative priority under section 503(b)(1)(B). (Emphasis added.)

It seems clear that the *Columbia Gas* court believes that the corporate Chapter 11 debtor could incur a tax within the meaning of § 503, in spite of the fact that under IRC §§ 1338 and 1339 no taxable estate is created in a corporate Chapter 11 bankruptcy. The same seems true for *In re Northeastern Ohio Gen. Hosp. Ass’n*, 126 B.R. 513, 515 (Bankr.N.D. Ohio 1991).

²⁷ The court found the § 503 legislative history unpersuasive because the phrase “taxes which the trustee incurs” has the same meaning as the phrase “taxes which the estate incurs.” It also found the § 1222 legislative history unpersuasive because Senator Grassley’s statement as to “tax liabilities generated during a bankruptcy reorganization” actually “concerns an unenacted bill in a Congress convened six years prior to the one that enacted § 1222(a)(2)(A).” (617 F.3d at 1167.)

²⁸ *In re Dawes*, 382 B.R. 509 (Bankr. Kan., 2008).

determine Congressional intent.” (382 B.R. at 515.) The court’s detailed analysis of legislative history led it to conclude that the phrase as it appears in § 503 refers to the *time* when the tax liability is incurred and not whether the estate is a separate taxable entity. The court refused to interpret § 1222(a)(2)(A) in the context of IRC §§ 1399 and 1398: “this Court has been unable to find any Chapter 12, or even any Chapter 7 or Chapter 11 case, where those IRC provisions were held to be relevant to the construction of the definition of administrative claim in § 503(b)(2)(B)(i). [] The fact that in a Chapter 12 case a new taxpayer is not created is not relevant to the allowance of post-petition taxes as administrative claims.” (382 B.R. at 520, 521.) The court also made a point of the fact that in prior pre-BAPCPA Chapter 12 cases, the IRS had taken the position that a claim arising from the debtor’s failure to pay post-petition employment taxes as they became due was an administrative expense subject to § 1222(a)(2).

In March 2009, the district court for Kansas affirmed the Kansas bankruptcy court decision in *Dawes*.²⁹ The district court rejected the IRS’s “separate entity” argument for application of IRC §§ 1338 and 1339. It cited for support the bankruptcy court’s discussion of the legislative history behind § 503, the *Knudsen* district court’s reliance on *O’Neill Shoe*, and its holding that nothing in the plan language of § 1222(a)(2)(A) restricts its applicability to pre-petition sales. It agreed with the *Knudsen* district court that since reorganization occurs both before and after the filing of a petition, § 1222(a)(2)(A) must apply to transactions that occur both before and after the petition. The court also quoted *Knudsen*’s admonition to the IRS that the relevant provisions are “not federal income tax provisions found in the Bankruptcy Code but are properly understood as bankruptcy provisions to be construed in accordance with the Bankruptcy code and bankruptcy policy to promote the effective reorganization of family farming operations.” (415 B.R. at 823.)

In June, 2011, shortly after the grant of certiorari by the Supreme Court in *Hall*, the Tenth Circuit reversed the district court in *Dawes* and held that § 1222(a)(2)(A) is not applicable to post petition taxes.³⁰ The court held that post-petition income taxes incurred during the Chapter 12 proceedings are liabilities of the individual debtor and not the bankruptcy estate. “As such they are not within the purview of the bankruptcy proceedings or included in the reorganization plan. Instead, the taxes are due from the debtor personally and the IRS’s recourse remains exclusively with the individual debtor, separate and apart from the Chapter 12 estate and unaffected by the bankruptcy discharge.” (Page 5.) The court based its holding on the plain language of the statute, the larger statutory structure and Congress’s expressed purposes.

First, the court found the plain meaning of the word “incurred” inescapably carries the sense of *being liable for*. “[O]nce we accept that one must be liable for an expense to have incurred it, it is the phrase ‘by the estate’ that poses the problem for the debtors.” (Page 10.)

As for reliance on IRC §§ 1338 and 1339, the court wrote:

²⁹ *In re Dawes*, 415 B.R. 815 (D. Kan., 2009).

³⁰ *United States v. Dawes (In re Dawes)*, Case No. 09-3129 (10th Cir. June 21, 2011).

Of course, Congress is free (and in some cases has chosen) to use the bankruptcy code to control certain aspects of how federal or state tax law operates during reorganizations. But, when the code hasn't told us otherwise, our attention is rightly turned to the underlying tax law to see who owes what. Indeed, bankruptcy law often relies on underlying income tax laws to assign priorities in bankruptcy. See, e.g., § 507(a)(8)(A)(i) (treatment of pre-petition tax turns on when the tax return was due); § 507(a)(8)(B) (treatment of property tax turns on when it was last payable without penalty); § 346 (commanding that state and local income taxes be allocated between debtor and bankruptcy estate in a way that generally follows their treatment under the federal Internal Revenue Code). When the bankruptcy code defers a question to existing tax law, our role is to apply that law, not to invent new rules of our liking. (Pages 6 and 7.)

The court then reviewed §§ 1398 and 1399 to find that “only the debtor and not the estate is liable for the payment” of the post-petition taxes, writing: “The estate may have once possessed the farm assets in question. The bankruptcy court may have authorized their sale. And the estate might well have caused a tax liability to arise. But none of this means the estate incurs those taxes. Only the [debtors] do.” (Page 8.)

Second, the court reviewed the larger structure of the Bankruptcy Code and found support for its decision as follows: 1) a review of other § 503 provisions shows that congress was “deliberately navigating the distinction between timing and identity when crafting § 503(b) and to accept the argument that “incurred by the estate” means incurred post-petition would trample the meaning of those other provisions; 2) to allow that post-petition taxes in Chapter 12 are incurred by the estate would require the same result in Chapter 13, and “[i]f post-petition taxes are automatically included in the bankruptcy plan as taxes ‘incurred by the estate,’ then § 1305(a)(1)'s optional inclusion of these same claims is left loitering around the U.S. Code with no apparent purpose” (Page 12); 3) the Bankruptcy Code specifically prohibits state and local income taxes from being either “taxed to” or “claimed by” a Chapter 12 estate, instead directing that these state and local taxes be the liabilities of the debtor. See § 346(b) (page 12).

Finally, as to the statutory purpose of § 1222(a)(2)(A), the Tenth Circuit stated: “Yet under our interpretation of § 503(b), income taxes incurred as a result of the pre-petition disposition of certain farm assets are eligible for § 1222(a)(2)(A)'s generous rule allowing them to be treated as unsecured claims, compromised, and discharged. [] Clearly, then, our reading gives respect to Congress's wish to provide a substantial form of special assistance targeted to farmers. We only stop short of extending § 1222(a)(2)(A)'s treatment to income taxes incurred post-petition by the debtor rather than the estate.”³¹

³¹ It is interesting to note that on this point there has actually not been an adjudication in the context of § 1222 as to meaning of post-petition and pre-petition. The Ninth Circuit in *Hall* stated that “there is no dispute that section 1222(a)(2)(A) allows chapter 12 debtors to treat *taxes* incurred by selling farm assets *before* the filing of a bankruptcy petition as payable in less than full and dischargeable.” (617 F.3d at 1163.) But see *In re Firestone*, 179 B.R. 148 (Bankr. D. Neb. 1995); it is not merely the fact of a sale of an asset pre-petition that determines whether or not the tax arising out of the sale is a pre- or post-petition tax.