TAKING EXCEPTION TO THE NEW CORPORATE DISCHARGE EXCEPTIONS

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I. INTRODUCTION

The 2005 amendments[1] to the Bankruptcy Code[2] are chock-full of sea-change revisions that strike at the most fundamental premises underlying federal bankruptcy law—changes that will force us to alter the way we think about and explain the rationality (or lack thereof) of bankruptcy law. One such provision is newly enacted section 1141(d)(6), which now provides for a limited discharge exception for certain debts of a *corporate* debtor in a chapter 11 case.[3] In particular, while Code section 1141(d)(1) has heretofore afforded a corporate debtor a comprehensive discharge (upon confirmation of a plan of reorganization) of *all* pre-confirmation debts,[4] section 1141(d)(6) now provides that "the confirmation of a plan does *not* discharge a debtor that is a *corporation* from"[5] the following fraud debts:

(1) a fraud debt (as defined by Code section 523(a)(2)(A)[6] or (B)[7])

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[1] Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, 119 Stat. 23 (to be codified in scattered sections of 11 U.S.C.).

[2] 11 U.S.C. §§ 101–1330 (2000).

[3] Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 § 708 (to be codified at 11 U.S.C. § 1141(d)(6)).

[4] 11 U.S.C. § 1141(d)(1)(A) (2000):

> [T]he confirmation of a plan discharges the debtor from any debt that arose before the date of such confirmation, . . . whether or not (i) a proof of the claim based on such debt is filed or deemed filed . . . ; (ii) such claim is allowed . . . ; or (iii) the holder of such claim has accepted the plan.

Before the 2005 amendments, particular kinds of debts were excepted from this discharge only in the case of an *individual* debtor. *See id*.; § 523(a) (providing "[a] discharge under section . . . 1141 . . . does not discharge an *individual* debtor from any debt" listed therein (emphasis added)); § 1141(d)(2) ("The confirmation of a plan does not discharge an *individual* debtor from any debt excepted from discharge under section 523 . . . ." (emphasis added)).

[5] Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 § 708 (emphasis added) (to be codified at 11 U.S.C. § 1141(d)(6)).

[6] To wit, "any debt for money, property, services, or an extension, renewal, or refinancing of credit, to the extent obtained by false pretenses, a false representation, or actual fraud, other than a statement respecting the debtor's or an insider's financial condition." 11 U.S.C. § 523(a)(2)(A).

[7] This is the provision respecting credit obtained through a fraudulent financial statement:

> "that is owed to a domestic governmental unit,"[8]
> (2) any such fraud debt that is owed to any other "person[9] as the result of an action filed under" the federal False Claims Act[10] "or any similar State statute"[11] providing for qui tam prosecution of governmental claims,[12] or
> (3) a tax debt with respect to which the debtor made a fraudulent return or willfully attempted in any manner to evade or defeat such tax.[13]

Among the multitude of discharge revisions enacted in the 2005 amendments,[14] section 1141(d)(6) may, at first blush, seem relatively innocuous[15] and even

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> [U]se of a statement in writing— (i) that is materially false; (ii) respecting the debtor's or an insider's financial condition; (iii) on which the creditor to whom the debtor is liable for such money, property, services, or credit reasonably relied; and (iv) that the debtor caused to be made or published with intent to deceive . . . .

11 U.S.C. § 523(a)(2)(B) (2000).

[8] Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 § 708 (to be codified at 11 U.S.C. § 1141(d)(6)(A)).

[9] The Bankruptcy Code defines a "person" to include an individual, partnership, or corporation, but *not* a governmental unit. *See* 11 U.S.C. § 101(41).

[10] The False Claims Act (FCA) is codified at 31 U.S.C. §§ 3729–33 (2000). The object of this aspect of new section 1141(d)(6)(A) is to render a debtor's fraud liability in an FCA qui tam action non-dischargeable.

[11] Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 § 708 (to be codified at 11 U.S.C. § 1141(d)(6)(A)).

[12] The qui tam provisions of the FCA permit a private plaintiff to bring a civil action under the FCA on behalf of the government, and if the action is successful, the private plaintiff receives a statutory bounty from the government's recovery. *See generally* QUI TAM LITIGATION UNDER THE FALSE CLAIMS ACT (Howard W. Cox & Peter B. Hutt II eds., 2d ed. 1999).

[13] Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 § 708 (to be codified at 11 U.S.C. § 1141(d)(6)(B)). "[A] willful attempt to evade or defeat a tax" is "a recognized extension of the doctrine of tax fraud." NAT'L BANKR. REVIEW COMM'N, BANKRUPTCY: THE NEXT TWENTY YEARS 953 (1997) [hereinafter 1997 COMMISSION REPORT]; *see* 26 U.S.C. §§ 6531(2), 6653(2), 6672(a), 7201. And the operative language of new section 1141(d)(6)(B) was taken, nearly verbatim, from the Code section 523(a)(1)(C) discharge exception applicable to individual debtors and, thus, simply made this discharge exception equally applicable to corporate debtors in chapter 11.

[14] *See generally* William Houston Brown, *Taking Exception to a Debtor's Discharge: The 2005 Bankruptcy Amendments Make It Easier*, 79 AM. BANKR. L.J. 419 (2005). For a good discussion of new section 1141(d)(6), see Richard Levin & Alesia Ranney-Marinelli, *The Creeping Repeal of Chapter 11: The Significant Business Provisions of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005*, 79 AM. BANKR. L.J. 603, 614–18 (2005).

[15] In fact, this was the initial position of the National Bankruptcy Conference with respect to the original version of what would ultimately become section 1141(d)(6). *See Bankruptcy Reform Act of 1998; Responsible Borrower Protection Act; and Consumer Lenders and Borrowers Bankruptcy Accountability Act of 1998: Hearings on H.R. 3150, H.R. 2500, and H.R. 3146 Before the Subcomm. on Commercial and Administrative Law of the H Comm. on the Judiciary*, 105th Cong., pt. III, at 282, 319-20 (1999) [hereinafter *H.R. 3150 Hearings*], *available at* http://commdocs.house.gov/committees/judiciary/hju58408.000/hju58408_0f.htm (last visited Nov. 13, 2005) (reprinting Nat'l Bankr. Conference, Section-by-Section Analysis of H.R. 3150) (taking position, with respect to H.R. 3150 section 509 regarding non-dischargeability of fraudulent taxes by corporate debtors in chapter 11, that "[t]his provision is unobjectionable"); *see also id*. at 447 (statement of Paul H. Asofsky, Tax Advisory Comm., Nat'l Bankr.

commendable,[16] by comparison. Some reflection, though, reveals section 1141(d)(6) to be a dangerous dilution of the essential function of a corporate discharge in chapter 11.

II. THE CHAPTER 11 CORPORATE DISCHARGE

A Fresh Start for the Corporate Person . . . Not

Understanding the corporate discharge in chapter 11 can be easily obstructed by the confluence of two pervasive, ingrained notions. The first is the driving force behind modern discharge policy. Discharge of indebtedness is federal bankruptcy law's ultimate expression of the now-venerable fresh start policy, through which bankruptcy relief "gives to the honest but unfortunate debtor . . . a new opportunity in life and a clear field for future effort, unhampered by the pressure and discouragement of preexisting debt."[17] Combine with (1) the bankruptcy discharge's visceral association with the fresh start policy (2) the law's recurring (to the point of reflexive) tendency to regard corporations as the equivalent of natural persons—the well-known corporate attribute of legal personhood.

All readily acknowledge that "a corporation's legal personality obviously is a fiction"[18] (because that's how my Corporations teacher described it—the "fiction" of a corporation as a legal person). The more pervasive and autonomic is the legal fiction, though, the more difficult it becomes to overcome the unconscious tendency to regard the fiction as truth. Indeed, it is that very tendency that makes the fiction of corporate legal personhood so useful and enduring. Thinking and speaking of a "corporation"—an abstraction representing a multitude of complex relationships—as if it were a real person, rather than speaking and thinking in terms of the Byzantine relationships implicated by anything a corporation "does," is a nearly indispensable simplifying convention.[19] That convention, though, inevitably obscures the relationships at stake, and the same is true of discharge of corporate

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Review Comm'n) (noting although "[a]rguably, the considerations are different for corporate debtors than they are for individuals. I have no strong views on this issue."). Within a matter of months, though, the National Bankruptcy Conference had changed its public position to question the advisability of this provision. *The Business Bankruptcy Reform Act: Hearings on S. 1914 Before the Subcomm. on Administrative Oversight and the Courts of the S. Comm. on the Judiciary*, 105th Cong., 1998 WL 268198 (May 19, 1998) (testimony of Randall C. Picker, Nat'l Bankr. Conference) (commenting, with respect to S. 1914 section 506 regarding non-dischargeabiltiy of fraudulent taxes by corporate debtors in chapter 11, "it is unclear why the reorganized debtor . . . should remain liable for these [fraudulent] taxes").

[16] *See S. Oversight Hearing: Hearing on the Bankruptcy Commission Rep. Before the Subcomm. on Administrative Oversight and the Courts of the S. Comm. on the Judiciary*, 105th Cong., 1997 WL 659260 (Oct. 21, 1997) (testimony of James I. Shepard, Comm'r and Bankr. Tax Consultant, Nat'l Bankr. Review Comm'n) (opining "[t]he proposal to amend Chapter 11 to provide that taxes arising from fraud be excepted from discharge" will "enhance the integrity of our tax system").

[17] Local Loan Co. v. Hunt, 292 U.S. 234, 244 (1934).

[18] STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS § 1.2, at 7 (2002).

[19] *See id.*; WILLIAM A. KLEIN & JOHN C. COFFEE, JR., BUSINESS ORGANIZATION AND FINANCE: LEGAL AND ECONOMIC PRINCIPLES 118 (9th ed. 2004).

debts in chapter 11.

It is extremely tempting to view the existence of a corporate discharge in chapter 11 as an extension of bankruptcy's fresh start policy to corporations. And as Justice Sutherland's classic articulation of the fresh start policy for the "honest but unfortunate debtor"[20] indicates, the dishonest or fraudulent debtor is *denied* relief. Thus, the extent of the discharge available has always been conditioned, to various degrees, upon the debtor's good faith,[21] and "[m]any non-dischargeable debts involve 'moral turpitude' or intentional wrongdoing."[22] One may wonder, then, why a corporation that has been the instrument of fraud (and in many cases, massive fraud, as recent history highlights) should be able to discharge its fraud debts in chapter 11.[23] Indeed, it was this very impulse that drove enactment of section 1141(d)(6). Part of the larger effort to ferret out perceived "abuses" of the bankruptcy system ostensibly necessitated "that this loophole be closed."[24]

Allowing corporations to discharge fraud debts in chapter 11 is a loophole, though, only if the chapter 11 discharge of corporate debts serves the same fresh start functions as does the discharge of individuals' debts. The fictional legal entity known as a corporation, however, needs no fresh start in the same sense as does an individual.[25] Individuals who own a corporation as shareholders already enjoy the liability shield flowing from the concept that the fictional corporate person is the entity liable for corporate debts.[26] A corporation can fully discharge its debts without bankruptcy, by merely dissolving the fictional corporate person.[27] Thus, the

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[20] *Local Loan Co*., 292 U.S. at 244.

[21] *See generally* Charles J. Tabb, *The Historical Evolution of the Bankruptcy Discharge*, 65 AM. BANKR. L.J. 325, 336–37, 339–42 (1991). In fact, the first English discharge statute not only denied "fraudulent bankrupts" a discharge, but also made conviction for same punishable by death. *See id*. at 336-37.

[22] 1997 COMMISSION REPORT, *supra* note 13, at 179.

[23] *See, e.g.*, KAREN GROSS, FAILURE AND FORGIVENESS: REBALANCING THE BANKRUPTCY SYSTEM 124–25 (1997); Jonathan C. Lipson, *Fighting Fiction with Fiction—The New Federalism in (a Tobacco Company) Bankruptcy*, 78 WASH. U. L.Q. 1271, 1288–89 (2000).

[24] *H.R. 3150 Hearings*, *supra* note 15, at 381 (statement of James I. Shepard, Comm'r and Bankr. Tax Consultant, Nat'l Bank. Review Comm'n).

[25] *See* REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. DOC. NO. 93-137, pt. I, at 74 (1973) [hereinafter 1973 COMMISSION REPORT]; Tabb, *supra* note 21, at 363; Elizabeth Warren, *Bankruptcy Policymaking in an Imperfect World*, 92 MICH. L. REV. 336, 341 (1993).

[26] As Professor Countryman put it, "for them the certificate of incorporation is a bankruptcy discharge in advance." *Bankruptcy Act Revision: Hearings on H.R. 31 and H.R. 32 Before the Subcomm. on Civil and Constitutional Rights of the H. Comm. on the Judiciary*, 94th Cong., pt. I, at 342, 352 (1975) [hereinafter *H.R. 31/32 Hearings*] (statement of Prof. Vern Countryman).

[27] *See* THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW 191 (1986); John D. Ayer, *The Role of Finance Theory in Shaping Bankruptcy Policy*, 3 AM. BANKR. INST. L. REV. 53, 64 (1995); Lynn M. LoPucki, *A General Theory of the Dynamics of the State Remedies/Bankruptcy System*, 1982 WIS. L. REV. 311, 324; Elizabeth Warren, *Bankruptcy Policy*, 54 U. CHI. L. REV. 775, 785 (1987). Recognition of this functional discharge equivalent is found in Code section 727(a)(1). When a corporation liquidates in chapter 7, all of the corporation's assets are distributed to creditors, leaving only a corporate shell. Section 727(a)(1) denies the resulting corporate shell a bankruptcy discharge. Likewise, if a corporate debtor's chapter 11 plan is a liquidating plan, the resulting corporate shell receives no chapter 11 discharge either. *See* 11 U.S.C. § 1141(d)(3) (2000).

unique function of the chapter 11 corporate discharge rests on grounds entirely different from those underlying an individual debtor's discharge.

B. The Plan Finality Function of the Chapter 11 Corporate Discharge

The chapter 11 corporate discharge merely gives effect to the process by which chapter 11 provides a reorganized debtor with a new capital structure.[28] A chapter 11 reorganization is accomplished via a class voting and treatment framework that contemplates dividing the value of a corporate debtor's business in a fashion that gives equal pro rata treatment to similarly situated claimants and that binds all parties, notwithstanding the dissent of particular claimants. The chapter 11 discharge is the mechanism by which all claimants are bound to the treatment provided by the plan.[29] The distinctive (if somewhat mundane) function of the chapter 11 discharge, then, is simply that of providing *plan finality*.[30] The overarching policy objectives embedded within this function are two: Because plan confirmation requires equal treatment of similarly situated creditors,[31] by giving finality to this treatment, the chapter 11 corporate discharge is merely a logical corollary of bankruptcy's creditor equality principles.[32] In addition, of course, plan finality furthers chapter 11's stated policy of reorganizing, rather than liquidating, viable businesses.[33]

The plan finality function of a chapter 11 corporate discharge indicates that the effect of carving out exceptions thereto are twofold: (1) providing a *de facto* priority to the excepted debts, and (2) preventing a restructuring of the excepted debts which, in extreme cases, could prevent reorganization and necessitate liquidation of the corporate debtor. The historical evolution of the corporate discharge in bankruptcy reorganization proceedings illustrates both of these points.

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[28] That the chapter 11 corporate discharge is simply effectuating a change in the corporation's capital structure is indicated by comparing the scope of the section 1141(d)(1) discharge with the Code's other discharge provisions, which only discharge "debt." *See* 11 U.S.C. §§ 524(a), 727(b), 1228(a), 1328(a) (2000). Unlike the others, section 1141(d)(1) not only "discharges the debtor from any debt," but it also "terminates all rights and interests of equity security holders." *Id*. § 1141(d)(1)(A)–(B). Thus, chapter 11 can provide a reorganized corporation a new capital structure, by comprehensively *extinguishing* the corporation's pre-bankruptcy capital structure.

[29] *See* John D. Ayer, *Through Chapter 11 with Gun or Camera, But Probably Not Both: A Field Guide*, 72 WASH. U. L.Q. 883, 890–91 (1994); Thomas H. Jackson & Robert E. Scott, *On the Nature of Bankruptcy: An Essay on Bankruptcy Sharing and the Creditors' Bargain*, 75 VA. L. REV. 155, 156 n.3 (1989); Charles J. Tabb, *The Future of Chapter 11*, 44 S.C. L. REV. 791, 805–06 (1993).

[30] Thus, "[i]n a reorganization case a corporation in effect obtains a discharge to the extent a reorganization plan binds creditors to satisfaction of less than the full amount of their claims." 1973 COMMISSION REPORT, *supra* note 25, pt. II, § 4-505 note 3, at 134.

[31] *See* 11 U.S.C. §§ 1122(a), 1123(a)(4), 1129(b)(1) (2000).

[32] *See* JACKSON, *supra* note 27, at 191–92.

[33] "The purpose of a business reorganization case, unlike a liquidation case, is to restructure a business's finances so that it may continue to operate, provide its employees with jobs, pay its creditors, and produce a return for its stockholders." H.R. REP. NO. 95-595, at 220 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6179.

III. CORPORATE DISCHARGE EXCEPTIONS UNDER THE 1898 ACT REORGANIZATION CHAPTERS

A: Chapter X: Discharge Exception = Distribution Priority

Comprehensive discharge of all debts in a corporate reorganization was a feature of the very first corporate reorganization statute, section 77B of the Bankruptcy Act of 1898, enacted in 1934,[34] and its successor, the chapter X corporate reorganization provisions enacted in 1938.[35] The necessity thereof for fully and successfully reorganizing overburdened corporate debtors (and inapplicability of the justifications for discharge exceptions) was readily apparent.[36]

The only limited exception to the chapter X discharge under the 1898 Act[37] was

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[34] Act of June 7, 1934, Pub. L. No. 73-296, § 77B(h), 48 Stat. 911, 920 (providing upon confirmation and consummation of plan, "final decree shall discharge the debtor from its debts and liabilities, and shall terminate and end all rights and interests of its stockholders, except as provided in the plan or as may be reserved" in the confirmation order). In enacting this provision, Congress specifically noted the plan finality function of the comprehensive discharge: "The plan when confirmed and carried out will set forth the capitalization of the reorganized company and there must be no uncertainty as to its finality . . . . The final decree will discharge the debtor from its debts and liabilities and will terminate and end all rights and interests of the stockholders . . . ." S. REP. NO. 73-482, at 9 (1934) (adopting and quoting H.R. REP. NO. 73-194).

[35] Chandler Act of 1938, Pub. L. No. 75-696, § 228(1), 52 Stat. 840, 899 ("Upon the consummation of the plan, the judge shall enter a final decree discharging the debtor from all its debts and liabilities and terminating all rights and interests of stockholders of the debtor, except as provided in the plan or in the order confirming the plan . . . .").

[36]

> In ordinary bankruptcy, the discharge of the bankrupt . . . is a matter of privilege granted to the bankrupt upon certain terms and which may be denied under certain circumstances. [Such provisions, however,] are inappropriate to and inconsistent with the provisions of § 228(1) and Chapter X as a whole, and are thus inapplicable to Chapter X cases. The reason . . . is to be found in the nature of the reorganization process. The chief purpose of the proceeding is to conserve the going-concern values of an enterprise and enable it to go forward in some form as a business entity. Accordingly, a discharge on a broad and final basis, consonant with the needs of the reorganization undertaken, is a requisite to a successful financial rehabilitation. On the other hand, a discharge in ordinary bankruptcy, while it is a privilege which may enable the bankrupt (often an individual) to start anew, is not essential to the liquidating distribution of the bankrupt's assets among his creditors. Hence, the discharge is hedged about with procedures, conditions, and requirements designed to compel the bankrupt to follow an honest course and, in a manner of speaking, "earn" his right to a fresh start . . . . Obviously, none of this has any connection with a Chapter X case, which is merely a statutory method for the overhauling of a corporation's financial and business structure.

6A COLLIER ON BANKRUPTCY ¶ 11.18, at 305–06 (James Wm. Moore ed., 14th ed. 1977) [hereinafter COLLIER (14th ed.)].

[37] Bankruptcy Act of 1898, Pub. L. No. 55-171, 30 Stat. 544 (amended 1903, 1906, 1910, 1915, 1916, 1917, 1922, 1926, 1932, 1933, 1934, 1935, 1936, 1937, 1938, 1939, 1940, 1942, 1944, 1946, 1947, 1948, 1950, 1951, 1952, 1953, 1956, 1957, 1958, 1959, 1960, 1962, 1963, 1964, 1965, 1966, 1967, 1970, 1973 &

for *priority* tax debts.[38] Excepting such taxes from a corporate debtor's discharge was in recognition of the government's administrative "difficulty of accurately determining the debtor's most recently accrued tax liabilities speedily enough to assert the claim in the reorganization case."[39] Thus, preserving the government's ability to receive full payment of such taxes through a discharge exception was simply a means to give full effect to the taxes' priority payment right.[40]

B. Chapter XI: An Impediment to Comprehensive Reorganization

The potential for such a corporate discharge exception (and *de facto* payment priority) to jeopardize prospects for a successful reorganization is illustrated by the more limited corporate discharge available in arrangement proceedings under chapter XI of the 1898 Act. Although chapter X was designed for reorganization of public corporations and chapter XI for smaller, closely held businesses, chapter XI nonetheless "evolved into the dominant reorganization vehicle and very substantial

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1976 and repealed 1978) [as amended through date of repeal, hereinafter Bankruptcy Act of 1898], *reprinted in* COLLIER ON BANKRUPTCY app. A, pt. 3(a) (Alan N. Resnick & Henry J. Sommer eds., 15th ed. rev. 2004).

[38] Section 271 of the 1898 Act provided:

> Any provision in this chapter to the contrary notwithstanding, all taxes which may be found to be owing to the United States or any State from a debtor within one year from the date of the filing of a petition under this chapter and have not been assessed prior to the date of the confirmation of a plan under this chapter, and all taxes which may become owing to the United States or any State from a receiver or trustee of a debtor or from a debtor in possession, shall be assessed against, may be collected from and shall be paid by the debtor or the corporation organized or made use of for effectuating a plan under this chapter: *Provided, however*, That the United States or any State may in writing accept the provisions of any plan dealing with the assumption, settlement, or payment of any such tax.

Chandler Act of 1938, Pub. L. No. 75–696, § 271, 52 Stat. 840, 904. All federal taxes were also entitled to an absolute payment priority under the terms of any chapter X plan. *See* United States v. Key, 397 U.S. 322, 325–28 (1970); Bankruptcy Act of 1898, *supra* note 37, § 199; William T. Plumb, Jr., *The Tax Recommendations of the Commission on the Bankruptcy Laws—Priority and Dischargeability of Tax Claims*, 59 CORNELL L. REV. 991, 1012–13 (1974). State taxes, though, were afforded priority in chapter X only indirectly, by virtue of the discharge exception of section 271. *See* 6A COLLIER (14th ed.), *supra* note 36, ¶ 15.13[1], at 915. chapter XI contained an identical discharge exception for certain priority tax debts. *See* Bankruptcy Act of 1898, *supra* note 37, § 397. As with the chapter X discharge exception, the chapter XI discharge exception for tax debts was also designed to merely effectuate the payment priority of such tax debts, which expressly extended to both federal and state taxes in chapter XI. *See* 9 COLLIER (14th ed.), *supra* note 36, ¶ 12.07[2]-[3]; Plumb, *supra*, at 1008–12.

[39] 6A COLLIER (14th ed.), *supra* note 36, ¶ 15.13[1], at 915.

[40] Congress also believed that fully preserving the government's payment rights would permit more fruitful negotiations with the government should circumstances present a "necessity of scaling down the [tax] indebtedness of the debtor corporation in order to make the plan successful." H.R. REP. NO. 75-1409, at 55–56 (1937); *see also* 6, pt. 2 COLLIER (14th ed.), *supra* note 36, ¶ 9.17, at 1653. Obviously, though, "[w]hether such a half-hearted bid actually ha[d] the effect Congress had in mind . . . may be doubted." 6A COLLIER (14th ed.), *supra* note 36, ¶ 15.13[1], at 918.).

debtors [we]re able to reorganize in Chapter XI."[41] The scope of the discharge (and, thus, the debts that could be compromised) in chapter XI, though, was not all-encompassing, as it was in chapter X.

A corporate debtor could be denied a chapter XI discharge altogether if the debtor had "been guilty of any of the acts or failed to perform any of the duties which would be a bar to the discharge of a[n individual] bankrupt."[42] Moreover, chapter XI provided that confirmation of a plan of arrangement discharged a corporate debtor "from all . . . unsecured debts and liabilities provided for by the arrangement," but expressly excluded from this discharge "such debts as . . . are not dischargeable" in an individual debtor's ordinary bankruptcy case.[43]

The corporate discharge exceptions in chapter XI—particularly the discharge exception for fraud debts—posed a substantial impediment to the ability of certain debtors to reorganize under that chapter. Of course, cases precipitated by massive fraud (where the debtor's fraud liability could easily exceed the going concern value of the debtor's business) could not be successfully prosecuted under chapter XI, as the non-dischargeability of fraud debt would preclude any attempt to even address the source of the business's financial distress. Even more significantly, though, the presence of the discharge exceptions supplied to any creditor who could assert colorable allegations of fraud, a credible threat to "opt out" of the chapter XI restructuring, in an attempt to receive a greater recovery than other creditors. Consequently, the chapter XI discharge exceptions invited holdout creditor problems of the sort that plague non-bankruptcy workouts and that are the very impetus for a federal bankruptcy reorganization process (that can fully bind dissenters to a restructuring plan).[44] U.S. Financial's attempted reorganization under

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[41] 1973 COMMISSION REPORT, *supra* note 25, pt. I, at 246.

[42] Bankruptcy Act of 1898, *supra* note 37, § 366(3). The modern-day equivalent of these discharge bars is found in 11 U.S.C. § 727(a) (2000).

[43] Bankruptcy Act of 1898, *supra* note 37, § 371. In full, the chapter XI discharge provision stated:

> The confirmation of an arrangement shall discharge a debtor from all his unsecured debts and liabilities provided for by the arrangement, except as provided in the arrangement or the order confirming the arrangement, but excluding such debts as, under section 17 of this Act, are not dischargeable.

Id. The arrangement provisions of chapter XI, enacted in the Chandler Act of 1938, superseded the composition provisions previously contained in sections 12 and 74 of the 1898 Act. *See generally* NATIONAL BANKRUPTCY CONFERENCE, 74TH CONG., ANALYSIS OF H.R. 12889, at 36–39 (Comm. Print 1936). Section 74 compositions had no express provision for *any* discharge of indebtedness thereunder. *See id*. at 38. Confirmation of a section 12 composition did operate to discharge debts, to the extent they would not be satisfied pursuant to the terms of the composition, but non-dischargeable debts (as specified in section 17 of the 1898 Act) were specifically excluded from the scope of this discharge. *See* Bankruptcy Act of 1898, Pub. L. No. 55-171, § 14c, 30 Stat. 544, 550 (repealed 1938) ("The confirmation of a composition shall discharge the bankrupt from his debts, other than those agreed to be paid by the terms of the composition and those not affected by a discharge.").

[44] *See* Ralph Brubaker & Kenneth N. Klee, Debate, *Resolved: The 1978 Bankruptcy Code Has Been a Success*, 12 AM. BANKR. INST. L. REV. 273, 275 (2004). As Professor Tabb put it, any reorganization

chapter XI was repeatedly cited as a prominent example of a reorganization manifestly thwarted by a few dissident creditors initiating eleventh-hour non-dischargeability actions.[45]

In the drafting of the Bankruptcy Code, with the resulting consolidation of reorganization provisions into a unitary reorganization process, the differing scope of the corporate discharge as between chapters X and XI received careful scrutiny.[46] And the decision to enact a corporate discharge even *more* comprehensive than that available under chapter X[47] was informed by the chapter XI experience[48] and the

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process that does not counter the holdout creditor problem—through an effective "subjugation of minority wishes to those of majority—is doomed to fail and is unworkable." Tabb, *supra* note 29, at 806.

[45] *See Bankruptcy Reform Act of 1978: Hearings on S. 2266 and H.R. 8200 Before the Subcomm. on Improvements in Judicial Machinery of the S. Comm. on the Judiciary* 682–83 (1978) (statement of Bankruptcy Judge Herbert Katz); *H.R. 31/32 Hearings*, *supra* note 26, pt. 3, at 1909 (statement of J. Ronald Trost, National Bankruptcy Conference). For a summary of the troubles leading to U.S. Financial's chapter XI filing, and noting the subsequent conversion to chapter X, see *Fabrikant v. Bache & Co. (In re U.S. Financial Securities Litigation)*, 609 F.2d 411, 413–15 (9th Cir. 1979).

[46] Congress cited the differing scope of the corporate discharge as among the most "essential differences between Chapters X and XI" requiring reconciliation in the consolidated, unitary chapter 11 reorganization process. 124 CONG. REC. 34,003 (1978) (statement of Sen. DeConcini); 124 CONG. REC. 32,404 (1978) (statement of Rep. Edwards). The floor statements of the foregoing floor managers of the 1978 legislation are "persuasive evidence of congressional intent," generally regarded as the equivalent of a conference report. Begier v. IRS, 496 U.S. 53, 64 n.5 (1990).

[47] The 1973 Commission originally proposed a corporate discharge upon confirmation of a plan of reorganization comparable to that available under chapter X—a comprehensive discharge of all debts, excepting only certain *priority* tax debts. *See* 1973 COMMISSION REPORT, *supra* note 25, pt. II, § 4-506(a), at 136; *Id.* § 7-311(c) & note 3, at 255; *Id.* § 7-315(e) & note 6, at 260. Subsequent bills introduced simultaneously—reflecting the Commission's proposals in one bill and the competing proposals of the National Conference of Bankruptcy Judges (NCBJ) in another—both adopted this same approach with respect to corporate discharge in reorganization. *See* S. 236, 94th Cong. §§ 4-506(a), 7-311(c), 7-315(e) (1975) (Commission bill); H.R. 31, 94th Cong. §§ 4-506(a), 7-311(c), 7-315(e) (1975) (Commission bill); S. 235, 94th Cong. §§ 4-506(a), 4-719(e), 7-309(c), 8-307(b) (1975) (NCBJ bill); H.R. 32, 94th Cong. §§ 4-506(a), 4-719(e), 7-309(c), 8-307(b) (1975); *H.R. 31/32 Hearings*, *supra* note 26, app. 1, at 156, 263, 269–70, 284 (displaying side-by-side comparison of provisions of Commission and NCBJ bills). The legislation that subsequently progressed through both the House and Senate, though differing in the precise details, likewise provided an exception to the corporate discharge in chapter 11 only for certain priority taxes. *See Bankruptcy Reform Act of 1978: Hearings on S. 2266 and H.R. 8200 Before the Subcomm. on Improvements in Judicial Machinery of the S. Comm. on the Judiciary*, 95th Cong. 3, 234–35, 244 (1978) (comparing sections 1141(d)(1)-(2) and 1146(e) of H.R. 8200 as reported by H. Comm. on Judiciary, Sept. 8, 1977, and S. 2266 as introduced in Senate, Oct. 31, 1977); H.R. REP. NO. 95-595, at 418, 421–22 (1977); S. 2266, 95th Cong. §§ 1141(d)(1)(A)-(B), 1146(e) (as reported by Subcomm. on Improvements in Judicial Machinery of S. Comm. on the Judiciary, May 17, 1978); S. REP. NO. 95-989, at 129–30, 133 (1978). The Senate Finance Committee proposed an expansion of the discharge exception to also encompass *non-priority* tax debts involving fraud in certain situations. *See* S. 2266, 95th Cong., §§ 1141(d)(2), 1146(d) (as reported by S. Comm. on Finance, Aug. 10, 1978); S. REP. NO. 95-1106, at 25, 28 (1978). In the subsequent resolution of differences (without a formal conference) as between bills passed by the House and Senate, not only was the expansion proposed by the Senate Finance Committee rejected, the limited corporate discharge exception for *priority* tax debts (that had been a feature of chapter X, chapter XI, the Commission proposal, and all of the bills in the 94th and 95th Congresses) was entirely eliminated. *See* 124 CONG. REC. 34,008, 34,017 (statement of Sen. DeConcini); 124 CONG. REC. 32,408, 32,418 (statement of Rep. Edwards).

[48] "[S]uccessful rehabilitation under chapter XI is often impossible for a number of reasons," including the fact that "a corporation in chapter XI may not be able to get a discharge in respect of certain kinds of claims including fraud claims, even in cases where the debtor is being operated under new management." 124 CONG. REC. 34,004-05 (statement of Sen. DeConcini); 124 CONG. REC. 32,405 (statement of Rep.

considered judgment that *any* corporate discharge exception "would leave an undesirable uncertainty surrounding reorganizations that is unacceptable."[49]

IV. ASSESSING THE CODE'S NEW CORPORATE DISCHARGE EXCEPTIONS

A. Discharge Exception = Accidental Distribution Priority

In its oblique priority implications, the corporate discharge exceptions of new Code section 1141(d)(6) typify one of the pervasive, characteristic features of the 2005 amendments: That which is cast as curbing debtor abuse primarily impacts the readjustment of the relative rights of creditors *inter se*. Code section 1141(d)(6) essentially elevates the payment priority of governmental units' fraud claims in chapter 11 reorganizations. Privileging the claims of governmental creditors over private creditors is not a particularly novel (or even objectionable) notion, in and of itself.[50] When the priority is achieved by accident, however, the law of unintended consequences will rule the day, and by promoting the priority rank of *fraud* claims of governmental units by indirection, section 1141(d)(6) unthinkingly reverses deliberate policy choices underlying the Code's explicit priority provisions.

1. Undoing the Policies of the Code's Explicit Priority Provisions

Once one moves further and further away from the approach of awarding priority in payment to *all* debts owing the Sovereign (or even to all *tax* debts owing the Sovereign), which has been the general drift of things over time,[51] it seems particularly inappropriate to prefer governmental claims over private creditor claims whenever the government's claim is linked to fraudulent conduct by the debtor.

Edwards). *See H.R. 31/32 Hearings*, *supra* note 26, pt. 3, at 1891 (statement of Harvey R. Miller, William J. Rochelle, Jr. & J. Ronald Trost, National Bankruptcy Conference) ("One change from existing law which is strongly endorsed by the NBC is the provisions of H.R. 31 and H.R. 32 which provide that *all* claims . . . are discharged upon confirmation of the plan . . . whether or not the creditor's claim would otherwise be nondischargeable in straight bankruptcy."). Even those who favored retention of a separate arrangement process modeled on chapter XI, nonetheless, favored elimination therefrom of the corporate discharge exceptions. *See* S. 235, 94th Cong. § 8-307(b) (1975) (NCBJ bill); H.R. 32, 94th Cong. § 8-307(b) (1975) (NCBJ bill); *The Bankruptcy Reform Act: Hearings on S 235 and S. 236 Before the Subcomm. on Improvements in the Judicial Machinery of the S. Comm. on the Judiciary*, 94th Cong., pt. II, at 402 (1975) (statement of Benjamin Weintraub, Esq. and Michael J. Crames, Esq.) (Recommendation 6(d)).

[49] 124 CONG. REC. 34,008 (1978) (statement of Sen. DeConcini); 124 CONG. REC. 32,408 (1978) (statement of Rep. Edwards).

[50] Over time, though, there has been a steadily increasing level of resistance to governmental priorities, even for tax debts. *See generally* Harold Marsh, Jr., *Triumph or Tragedy? The Bankruptcy Act Amendments of 1966*, 42 WASH. L. REV. 681, 729–31 (1967). Indeed, the National Bankruptcy Conference has characterized the instinct toward "treating governmental obligations as more important and more privileged than obligations owed private investors [a]s a hallmark of discredited third-world legal systems." NAT'L BANKR. CONFERENCE, DISCHARGEABILITY OF CORPORATE DEBT UNDER S.220 (107TH CONG.), at 2 (1999), *available at* http://www.nationalbankruptcyconference.org/documents/DischargeofCorpDebt2.pdf (last visited Dec. 18, 2005).

[51] *See generally* Plumb, *supra* note 38, at 1008–12.

This involves the inescapable implication that innocent creditors are being punished for the debtor's nefarious deeds (which those creditors were likely in no position whatsoever to anticipate, discover and/or prevent). Consequently, even in the liquidation case of an individual debtor (where we can and do punish the individual debtor by withholding discharge of tax fraud debts, *e.g.*),[52] tax fraud claims are specifically denied any priority in the distribution of the debtor's estate.[53] As Congress recognized, "it is not fair to penalize private creditors of the debtor by [first] paying out of the 'pot' of assets in the estate tax liabilities arising from the debtor's deliberate misconduct."[54] Code section 1141(d)(6), though, does just that.

The *de facto* priority awarded governmental fraud claims in section 1141(d)(6) even goes beyond an implicit priority for obligations Congress consciously sought to deny any priority status, it also gives priority to claims for which the Code, on its face, provides for *subordination*. Code section 726(a)(4)'s subordination of claims "for any fine, penalty, or forfeiture, or for multiple, exemplary, or punitive damages"[55] is also operative in chapter 11 through the classification and absolute priority structure.[56] Yet, the debts designated for a practical payment priority under section 1141(d)(6) include "any debt of a kind specified in" section 523(a)(2)(A) or (B), which the Supreme Court has told us can properly include punitive, non-compensatory sums.[57] That which Congress sought to subordinate, then, is *both* resurrected from burial beneath the claims of general unsecured creditors *and* set

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[52] *See* 11 U.S.C. § 523(a)(1)(C) (2000).

[53] This choice is evident in the general parallelism between priority and non-dischargeability of tax debts, a concept that was elevated to precise correlation in the 1966 amendments to the 1898 Act. *See* Frank R. Kennedy, *The Bankruptcy Amendments of 1966*, 1 GA. L. REV. 149, 180–81 (1967). "[T]he 1966 legislation preserved the Government's priority for every tax for which Congress for any reason denied the debtor a discharge." Plumb, *supra* note 38, at 1028. In the drafting of the Bankruptcy Code, though, the 1973 Commission made a conscious decision to partially decouple the priority and dischargeability issues as respects tax debts non-dischargeable by reason of fraud, "by relieving innocent creditors of the burden of the Government's priority for noncurrent taxes for which the debtor filed a fraudulent return or no return, but retaining the denial of discharge in such cases." *Id*. at 1028–29.

> [F]raud or willful neglect on the part of the bankrupt may be a sufficient justification for withholding discharge from a liability arising out of or otherwise related to the bankrupt's conduct, but it does not necessarily furnish a reason for according priority to such liability over debts owing other innocent creditors.

Kennedy, *supra*, at 180. "[T]here is justice in denying him a discharge, but gross inequity in penalizing his innocent creditors by subjecting them to the priority of an unlimited accumulation of such tax liabilities." Plumb, *supra* note 38, at 1052. And it is this rationale that undergirds the relationship between Code sections 507(a)(8) (priority tax claims) and 523(a)(1) (non-dischargeable tax debts = priority tax debts + fraudulent tax debts). *See* S. REP. NO. 95-989, at 14 (1978).

[54] S. REP. NO. 95-1106, at 22 n.19 (1978).

[55] 11 U.S.C. § 726(a)(4) (2000).

[56] *See* Ralph Brubaker, *Punitive Damages in Chapter 11: Of Categorical Disallowance, Equitable Subordination, and Subordination by Classification*, 25 BANKR. L. LETTER No. 7, July 2005, at 1, 6–10.

[57] *See* Cohen v. de la Cruz, 523 U.S. 213, 221–22 (1998) ("When construed in the context of the statute as a whole . . . § 523(a)(2)(A) is best read to prohibit the discharge of any liability arising from a debtor's fraudulent acquisition of money, property, etc., including an award for treble damages for the fraud.").

atop those claims.

The same will be true to the extent that a governmental unit has a fraud claim arising from purchase or sale of a security of the debtor. Such claims are expressly subordinated under Code section 510(b), "to prevent disappointed shareholders from recovering their investment loss by using fraud and other securities claims to bootstrap their way to parity with general unsecured creditors in a bankruptcy proceeding."[58] New Code section 1141(d)(6), though, permits governmental fraud claims to go one better, by leapfrogging *over* general creditor claims.

2. Punishing Innocent Creditors

The new corporate discharge exceptions of Code section 1141(d)(6) undermine all these quite sensible policy judgments regarding relative inter-creditor priorities in what seems to be an attempt to punish a corporate debtor for such fraudulent misconduct. Any effort to punish a corporation, though, must inevitably confront the reality that the fiction of corporate personhood is just that (a fiction), and the corporation itself has "no soul to damn" and "no body to kick."[59] "All punishments inflicted on a corporation in name are collected from investors in fact,"[60] and insolvency of the corporation, in particular, is the point at which theories of effective "corporate" punishment tend to break down.[61] The burden of the new corporate discharge exceptions for governmental fraud claims will be visited principally upon innocent creditors, not the corporate agents that perpetrated the fraud.[62]

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[58] Hill Invs., Ltd. v. Telegroup, Inc. (*In re* Telegroup, Inc.), 281 F.3d 133, 142 (3rd Cir. 2002); *see* John J. Slain & Homer Kripke, *The Interface Between Securities Regulation and Bankruptcy – Allocating the Risk of Illegal Securities Issuance Between Securityholders and the Issuer's Creditors*, 48 N.Y.U. L. REV. 261, 268 (1973) ("Investors in stock or in subordinated debentures may be able to bootstrap their way to parity with, or preference over, general creditors . . . ."). Code section 510(b) is a codification of the proposal put forth in the Slain and Kripke law review article. *See* H.R. REP. NO. 95-595, at 194–96 (1977).

[59] John C. Coffee, Jr., *"No Soul to Damn: No Body to Kick": An Unscandalized Inquiry into the Problem of Corporate Punishment*, 79 MICH. L. REV. 386, 386 (1981) ("Did you ever expect a corporation to have a conscience, when it has no soul to be damned, and no body to be kicked?" (quoting Edward, First Baron Thurlow)).

[60] Olympia Equip. Leasing Co. v. W. Union Tel. Co., 786 F.2d 794, 803 (7th Cir. 1986) (Easterbrook, C.J., concurring).

[61] *See* Coffee, *supra* note 59, at 389–93, 408; Mark A. Cohen, *Theories of Punishment and Empirical Trends in Corporate Criminal Sanctions*, 17 MANAGERIAL & DECISION ECON. 399, 406-09 (1996); V.S. Khanna, *Corporate Criminal Liability: What Purpose Does It Serve?*, 109 HARV. L. REV. 1477, 1496 & n.110 (1996); Reinier H. Kraakman, *Corporate Liability Strategies and the Costs of Legal Controls*, 93 YALE L.J. 857, 867–76 (1984); Christopher Kennedy, Note, *Criminal Sentences for Corporations: Alternative Fining Mechanisms*, 73 CAL. L. REV. 443, 448–49 & n.28, 457–58, (1985).

[62] An intriguing proposal put forth by the Senate Finance Committee, but ultimately rejected, during the legislative process preceding enactment of the original Bankruptcy Code would have made tax fraud debts (within the meaning of section 523(a)(1)(B) or (C)) non-dischargeable in a corporate chapter 11 case, "unless equity security holders of the debtor, as of the commencement of the case, do not retain or receive, by reason of their equity ownership, any debt or equity interest in the debtor or successor to the debtor under the plan." S. 2266, 95th Cong. § 1141(d)(2)(A)(iii) (as reported by the S. Comm. on Finance, Aug. 10,

B. An Impediment to Comprehensive Reorganization

The obstacles the new corporate discharge exceptions pose for successfully reorganizing under chapter 11 are muted somewhat by the fact that they are limited to fraud debts owing governmental units. This will be small comfort, however, to struggling Medicare or Medicaid providers, susceptible to allegations of False Claims Act violations,[63] which even private parties can assert on behalf of the government under the qui tam provisions of the False Claims Act.[64] Equally unmollified will be any business with a substantial government-sponsored loan or government contract, which in connection with the debtor likely made various financial and other representations on which the government may be able to construct colorable fraud allegations under either section 523(a)(2)(A) or (B).[65]

1978).

The idea behind this approach was that pre-bankruptcy shareholders are the only investors properly charged with the pre-bankruptcy fraud of corporate agents. Thus, "if former creditors or new outside investors take over complete ownership of a corporate debtor, it is not equitable to require the new owners in effect, to bear the burden of tax liability attributable to these kinds of fault by the prior owners" or their agents, but that "[t]his rationale should not provide relief from these taxes . . . if the same former owners emerge from the proceeding still in control of the company." S. REP. NO. 95-1106, at 25 (1978). Indeed, that the full panoply of discharge exceptions was applicable to corporate debtors under former chapter XI was, to some extent, a corollary of the fact that the absolute priority rule (preventing equity from retaining any interest in the reorganized debtor if creditors were not paid in full) was inoperative in chapter XI cases. *See H.R. 31/32 Hearings*, *supra* note 26, pt. 3, at 1907 (statement of Bankruptcy Judge Herbert Katz) ("for a chapter XI case . . . that's probably a pretty good provision, that the debtor is allowed to retain some interest in his business, then he should not be able to escape from his sins").

It is not at all clear, though, that the dynamics by which equity often receives a distribution or retains an interest in the reorganized debtor under chapter 11's modified absolute priority rule would effect a dollar-for-dollar diminishment of equity's "take" as an offset to the reorganized debtor's continuing liability for pre-bankruptcy tax fraud debts. *See generally* Douglas G. Baird & Thomas H. Jackson, *Bargaining After the Fall and the Contours of the Absolute Priority Rule*, 55 U. CHI. L. REV. 738 (1988); Lynn M. LoPucki & William C. Whitford, *Bargaining Over Equity's Share in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 139 U. PA. L. REV. 125 (1990). Stated differently, the Senate Finance Committee proposal was not precisely calibrated to punish *only* pre-bankruptcy equity through non-dischargeability of tax fraud debts; pre-bankruptcy creditors likely would have borne some (if not most) of the burden also. And Congress ultimately rejected the Senate Finance Committee proposal, noting that the only properly calibrated response to tax fraud by corporate agents would be "for the Congress to consider in the future imposing civil or criminal liability on corporate officers for preparing a false or fraudulent tax return." 124 CONG. REC. 34,017 (1978) (statement of Sen. DeConcini); 124 CONG. REC. 32,418 (1978) (statement of Rep. Edwards). Congress, however, has not generally seen fit to do so. *See infra* notes 82–86 and accompanying text. And it is this "gap" in tax law that was the impetus for what grew into Code section 1141(d)(6). *See infra* notes 78–93 and accompanying text.

[63] Indeed, the 1997 "Turnaround of the Year" (as awarded by the Turnaround Management Association), involving the nation's largest privately held home healthcare company, whose financial troubles included a conviction for Medicare fraud, is illustrative of such a case that will now be much more difficult (if not impossible) to reorganize under chapter 11. *See First American: The TMA's Turnaround of the Year*, 31 BANKR. CT. DECISIONS WEEKLY NEWS & COMMENT No. 18, Dec. 23, 1997, at A1.

[64] *See supra* note 12.

[65] *See* Levin & Ranney-Marinelli, *supra* note 14, at 615.

Moreover, the complexities and uncertainties the corporate discharge exceptions interject into the reorganization process will be exacerbated by a procedural ambiguity. Complaints to except the fraud debt of an individual debtor from discharge under Code section 523(a)(2) can only be filed in the federal bankruptcy court presiding over the debtor's bankruptcy case[66] and must be filed shortly after commencement of the bankruptcy case.[67] It is unclear, however, whether *any* of the fraud debts specified in section 1141(d)(6) are (and some clearly are not) subject to this exclusive jurisdiction/expedited determination scheme.[68] This permits a non-dischargeability claim with respect to a particular corporate debt to be filed (1) in the bankruptcy court *or* in any non-bankruptcy court with jurisdiction over an action on the underlying debt[69] and (2) "at any time"[70] before expiration of the statute of limitations on the underlying debt, even *post*-confirmation. As this expands the stratagems governmental creditors can now employ in an attempt to get a leg-up on other creditors, it will simultaneously cast a pall of incertitude over the effectiveness of the restructuring achieved through confirmation of a plan of reorganization.

C. Mooting the New Corporate Discharge Exceptions Through Asset Sales

Perhaps the most damning critique of the new corporate discharge exceptions is that they are easily evaded. As the origins of corporate reorganization law in the equitable receivership (looking to a foreclosure "sale" of the debtor's business and assets) illustrates,[71] a functional substitute for an "internal reorganization" of a

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[66] *See* 11 U.S.C. § 523(c)(1) (2000); FED. R. BANKR. P. 4007 advisory committee note (noting "[t]he bankruptcy court has exclusive jurisdiction to determine the dischargeability of these debts" specified in section 523(c)(1), including section 523(a)(2) fraud debts); Ralph Brubaker, *On the Nature of Federal Bankruptcy Jurisdiction: A General Statutory and Constitutional Theory*, 41 WM. & MARY L. REV. 743, 911–12 n.590 (2000).

[67] *See* FED. R. BANKR. P. 4007(c). "If a complaint is not timely filed" alleging nondischargeabilty under section 523(a)(2), "the debt is discharged." FED. R. BANKR. P. 4007 advisory committee note.

[68] Section 523(c)(1) (and, thus, Rule 4007(c)) applies only to "a debt of a kind specified in paragraph (2)" of section 523(a), and section 523(a), by its terms, excepts from the discharge of section 1141 certain debts of "an individual debtor" only. *See* 11 U.S.C. §§ 523(c)(1), 523(a) (2000). By excepting debts of a *corporate* debtor from discharge, then, new section 1141(d)(6) does not seem to be within the scope of section 523(c)(1), even to the extent that it incorporates certain (but not all) fraud debts "of a kind specified in paragraph (2)(A) or (2)(B) of section 523(a)." Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 § 708 (to be codified at 11 U.S.C. § 1141(d)(6)(A)).

[69] *See* Ralph Brubaker, *Of State Sovereign Immunity and Prospective Remedies: The Bankruptcy Discharge As Statutory* Ex Parte Young *Relief*, 76 AM. BANKR. L.J. 461, 514–15, 526–27 & n.281 (2002); Ralph Brubaker, *The Impact of the Discharge Injunction on State-Court Dischargeability Determinations*, 22 BANKR. L. LETTER No. 8, Aug. 2002, at 7, 8–10; Ralph Brubaker, *Criminal Prosecutions, Statutory Bankruptcy Injunctions, and the Preclusive Effect of State-Court Determinations*, 20 BANKR. L. LETTER No. 5, May 2000, at 1, 5-6.

[70] FED. R. BANKR. P. 4007(b).

[71] *See generally* Bruce A. Markell, *Owners, Auctions, and Absolute Priority in Bankruptcy Reorganizations*, 44 STAN. L. REV. 69, 74–90 (1991); Donald R. Korobkin, *Rehabilitating Values: A Jurisprudence of Bankruptcy*, 91 COLUM. L. REV. 717, 744–55 (1991).

corporation is a going-concern sale of the corporation's business and assets (with distribution of the proceeds to pre-bankruptcy claimants in accordance with their relative priority rights), and vice versa.[72]

When a corporate debtor's assets are sold, in lieu of an internal reorganization, the functional equivalent of discharge is the free-and-clear sale order,[73] "discharging" the assets and the purchaser from claims by the debtor's creditors and, thus, limiting those creditors' recourse to the sales proceeds.[74] Code section 1141(d)(6) contains no exemption from the effects of a free-and-clear sale order for the corporate fraud debts delineated therein. Sale in lieu of internal reorganization, therefore, presents a straightforward means by which to, in effect, "discharge" the corporate fraud debts delineated in section 1141(d)(6), notwithstanding its nominal discharge exception. And because the priority of such fraud debts is achieved only indirectly, and not through an explicit alteration of the Code's priority provisions, "discharge" by sale will also effectively undo the priority implications of Code section 1141(d)(6).

There has been a perceptible shift toward more and more asset sales in chapter 11.[75] One can expect that cases in which potential section 1141(d)(6) debts loom largely will witness a technical[76] (if not actual) "sale" capable of entirely mooting that provision.[77]

V. CONCLUSION: THE CHALLENGE OF ARTICULATING A LIMITING PRINCIPLE FOR AN UNPRINCIPLED PROVISION

If section 1141(d)(6) were nothing more than an ill-conceived provision that sophisticated counsel will draft around, it would not warrant comment beyond

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[72] "Reorganization proceedings . . . are basically a method by which the sale of a firm as a going concern may be made to the claimants themselves" Jackson, *supra* note 27, at 211; *accord* Robert C. Clark, *The Interdisciplinary Study of Legal Evolution*, 90 YALE L.J. 1238, 1252–53 (1981).

[73] *See* 11 U.S.C. §§ 363(f), 1141(c) (2000).

[74] *See* Ralph Brubaker, *Successor Liability and Bankruptcy Sales: Free and Clear of What?*, 23 BANKR. L. LETTER No. 6, June 2003, at 6.

[75] *See* Brubaker & Klee, *supra* note 44, at 283–84. The extent to which asset sales are displacing the traditional internal reorganization, though, is subject to debate. *Compare* Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy*, 55 STAN. L. REV. 751 (2002), *and* Douglas G. Baird & Robert K. Rasmussen, Reply, *Chapter 11 at Twilight*, 56 STAN. L. REV. 673 (2003), *with* Lynn M. LoPucki, Response, *The Nature of the Bankrupt Firm: A Reply to Baird and Rasmussen's* The End of Bankruptcy, 56 STAN. L. REV. 645 (2003).

[76] Reminiscent of the technical foreclosure "sale" in equitable receiverships, that was the precursor to the modern-day plan of reorganization. *See supra* note 71 and accompanying text.

[77] Interestingly, the corporate discharge exception that prevailed under former chapter X—consciously designed as a priority provision, to complement express priority for certain taxes—was careful to prevent such an evisceration of its effect, by providing that the priority tax debts excepted from discharge "may be collected from and shall be paid by the debtor *or the corporation organized or made use of for effectuating a plan under this chapter*." Bankruptcy Act of 1898, *supra* note 37, § 271 (emphasis added). The same was true of the corporate discharge exceptions proposed (but ultimately rejected) in the legislative process preceding enactment of the original 1978 Bankruptcy Code. *See supra* note 47.

flagging its effects (for sophisticated counsel to draft around) and noting the inequity visited upon those caught unaware (and those who must pay for sophisticated counsel to draft around ill-conceived provisions). My larger concern with section 1141(d)(6), though, lies in its capacity to conflate the distinctive policies and functions of the discharge of an individual debtor, on the one hand, and discharge of a corporate debtor, on the other. It tempts us to regard the fiction of corporate personhood as truth and, thereby, invites further incursions upon the integrity of the corporate discharge. Indeed, the legislative process leading to the enactment of Code section 1141(d)(6) illustrates both of these phenomena.

What became new Code section 1141(d)(6) originated in a 1997 proposal of the National Bankruptcy Review Commission, at the instance of the Commission's Tax Advisory Committee,[78] to amend the chapter 11 discharge provision "to except from discharge taxes unpaid by business entities, which nonpayment arose from fraud."[79] And admittedly, corporate tax fraud is particularly problematic when the corporation proves insolvent. The reason, however, relates to tax law's overindulgence of the fiction of corporate personhood, beyond even the norm for general corporate law.

A corporate agent who engages in wrongful conduct, such as fraud, is directly responsible as a tortfeasor and is not shielded from liability by virtue of the fact that the agent's fraudulent conduct was taken on behalf of a corporate principal.[80] Because a corporation (a fictional person) cannot "do" anything, except through the actions of its corporate agents (real people), the corporation's fraud liability is purely *vicarious* liability, through which the corporation (*i.e.*, the corporate property) is *also* subjected to liability for the corporate agent's fraudulent conduct.[81]

Tax law, however, takes the fiction of corporate personhood one step further, and declares the corporation *directly* responsible for tax fraud,[82] and in the process, the corporate agent (who actually committed the fraud) generally escapes any civil liability for those taxes[83]—a conceptual move that is often attempted in an effort to

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[78] *See* FINAL REPORT OF THE TAX ADVISORY COMMITTEE TO THE NATIONAL BANKRUPTCY REVIEW COMMISSION 16 (Aug. 1997) (Proposal 325), *available at* http://govinfo.library.unt.edu/nbrc/report/f1.pdf (last visited Nov. 12, 2005).

[79] 1997 COMMISSION REPORT, *supra* note 13, at 955 (Recommendation 4.2.8).

[80] *See* RESTATEMENT (SECOND) OF AGENCY § 343 (1958) ("An agent who does an act otherwise a tort is not relieved from liability by the fact that he acted at the command of the principal or on account of the principal . . . ."); *id*. § 359A ("A servant or other agent is not relieved from criminal liability for conduct otherwise a crime because of a command by his principal.").

[81] *See id*. § 257.

[82] The Internal Revenue "Code treats each C corporation as an independent tax-paying entity." BORIS I. BITTKER & JAMES E. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 1.05[1][a], at 1-12 (7th ed. 2000). And it is only in limited circumstances, specified by statute, that "a person other than the 'taxpayer' can be liable for a taxpayer's tax liability and penalties for its nonpayment." PATRICIA T. MORGAN, TAX PROCEDURE AND TAX FRAUD 214 (1999).).

[83] The Internal Revenue Code does provide for penalties against an "income tax return preparer," but the penalties are fairly modest, and the IRS's "one preparer per firm" rule ensures that only one corporate employee can be subjected to these penalties. *See* MICHAEL I. SALTZMAN, IRS PRACTICE AND PROCEDURE ¶

insulate corporate agents from personal liability for their misdeeds.[84] Of course, "[a] fiction taken seriously, *i.e.*, 'believed,' becomes dangerous and loses its utility."[85] And steeped in this fictional way of thinking—that the "person" responsible for corporate tax fraud is the corporate "taxpayer"—it is much easier to convince oneself (consistent with the fiction of corporate personhood) that the corporate taxpayer's punishment for tax fraud should not end with civil and criminal penalties, but should also include non-dischargeability in bankruptcy, "consistent with the notion that [only] the honest debtor is deserving of the bankruptcy discharge and reestablishment as a productive and taxpaying member of society."[86]

If this is an appropriate response to corporate fraud, though, why should it be limited to tax fraud? Why not make all corporate fraud debts non-dischargeable in bankruptcy? Better yet, why not make the full panoply of debts non-dischargeable by an individual debtor also non-dischargeable in the case of a corporate debtor? And not surprisingly, proposed legislation incorporating the Commission's very limited tax fraud proposal[87] soon morphed into legislative proposals to except from

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4.06, at 4-68 & ¶ 4.06[1][a], at 4-71, 4-73 to -74 (rev. 2d ed. 2004). Criminal penalties, however, can be imposed on a broader class of persons. *See id.* ¶ 7A.04[2].

[84] This is one of the arguments proffered in an attempt to justify non-debtor releases in chapter 11. *See* Ralph Brubaker, *Bankruptcy Injunctions and Complex Litigation: A Critical Reappraisal of Non-Debtor Releases in Chapter 11 Reorganizations*, 1997 U. ILL. L. REV. 959, 984 n.88.

[85] LON L. FULLER, LEGAL FICTIONS 9–10 (1967). "The problem with legal fictions is that all too often we convince ourselves that the fiction is real. Legal fictions, though, are created solely to achieve particular objectives that are easily forgotten when we permit the legal fiction to take on a life of its own." Ralph Brubaker, *From Fictionalism to Functionalism in State Sovereign Immunity*, 13 AM. BANKR. INST. L. REV. 59, 122–23 n.320 (2005). As Lord Justice Mansfield put it, "fictions of law hold only in respect to the ends and purposes for which they were invented." Morris v. Pugh, 3 Burr. 1242, 1243 (1761) (Mansfield, L.J.).

[86] 1997 COMMISSION REPORT, *supra* note 13, at 953-54. This proposal was not without its detractors, though. Professor Grant Newton, a member of the Commission's Tax Advisory Committee, repeatedly voiced stringent objections, arguing that "[t]he Service should file criminal action against the corporate officer that filed a fraudulent return, but creditors should not be punished because of the errors of prior management." *H.R. 3150 Hearings*, *supra* note 15, at 400; *see also The Business Bankruptcy Reform Act; Business Bankruptcy Issues in Review: Hearings on S 1914 Before the Subcomm. on Administrative Oversight and the Courts of the S. Comm. on the Judiciary*, 105th Cong., 1998 WL 265187 (May 19, 1998) (statement of Prof. Grant W. Newton).) Others voiced similar concerns. *See also Bankruptcy Reform Act of 1999: Hearings on H.R. 833 Before the Subcomm. on Commercial and Administrative Law of the H. Comm. on the Judiciary*, 106th Cong., pt. I, at 294 (2000), *available at* http://commdocs.house.gov/committees/judiciary/hju62437.000/hju62437_0f.htm (last visited Nov. 13, 2005) (statement of Leon S. Forman, Esq.) (characterizing this proposal as "an unfortunate erosion of the complete discharge provided to a corporate debtor when a chapter 11 plan is confirmed"); *Bankruptcy Reform Act of 1999: Hearings on H.R. 833 Before the Subcomm. on Commercial and Administrative Law of the H. Comm. on the Judiciary*, 106th Cong., pt. II, at 248 (2000), *available at* http://commdocs.house.gov/committees/judiciary/hju63593.000/hju63593_0f.htm (last visited Nov. 13, 2005) (reprinting National Bankruptcy Conference, Section-by-Section Analysis of the Bankruptcy Reform Act of 1999) ("The National Bankruptcy Conference urges deletion of this section . . . . It is inappropriate to punish creditors for failures of prior ownership or management").

[87] In the 105th Congress, legislation in both houses would have added the following section 1141(d)(6) to the Code:

> Notwithstanding the provisions of paragraph (1), the confirmation of a plan does not discharge a debtor which is a corporation from any debt for a tax or customs duty with

discharge in a corporate chapter 11 case (1) *all* section 523(a)(2) fraud debts,[88] and (2) *all* section 523(a) debts.[89] Indeed, the legislation approved by both houses of the 106th Congress (and that President Clinton pocket vetoed) contained *both* of those non-dischargeability features.[90]

A chorus of objections,[91] particularly from the National Bankruptcy Conference,[92] prompted a scaling-back of the corporate discharge exceptions to

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> respect to which the debtor made a fraudulent return or willfully attempted in any manner to evade or defeat such tax.

H.R. 3150, 105th Cong. § 509 (as reported by the H. Comm. on Judiciary, May 18, 1998); *accord* S. 1914, 105th Cong. § 506 (1998). This provision was in the bill passed by the House (H.R. 3150), and it also appeared in the conference report, agreed to in the House (but not the Senate). *See* H.R. REP. NO. 105-794, § 808, at 71 (1998) (Conf. Rep.).

The major bills introduced in both houses in the 106th Congress contained this same provision. *See* S. 625, 106th Cong. § 708 (as reported by the S. Comm. on Judiciary, May 11, 1999); H.R. 833, 106th Cong. § 808 (as reported by the H. Comm. on Judiciary, Apr. 29, 1999).

[88] In the 106th Congress, after passage of bills by both houses, the conference committee amended the provision regarding non-dischargeability of tax fraud debts (*see supra* note 87) to *also* provide that "the confirmation of a plan does not discharge a debtor that is a corporation from *any* debt described in section 523(a)(2)." H.R. REP. NO. 106-970, § 708, at 96 (2000) (Conf. Rep.) (emphasis added); S. 3186, 106th Cong. § 708 (2000) (emphasis added) (reflecting conference committee's changes). "Congress believes the Bankruptcy Code should not encourage fraud by allowing the discharge of debts incurred through fraud or false representation simply because those debts were incurred in a corporate setting." 146 CONG. REC. S11,715 (daily ed. Dec. 7, 2000) (statement of Sen. Grassley).

[89] The bill initially passed by the Senate in the 106th Congress would have amended section 1141(d)(2)—providing that confirmation of a plan of reorganization does not discharge "an *individual* debtor" from any debt non-dischargeable under section 523(a)—to provide that "[a] discharge under this chapter [11] does not discharge *a debtor* from any debt excepted from discharge under section 523." H.R. 833, 106th Cong. § 321(d) (as passed in Senate, Feb. 2, 2000). The legislation subsequently produced by the conference committee also contained this provision. *See* H.R. REP. NO. 106-970, § 321(d), at 69 (2000) (Conf. Rep.); S. 3186, 106th Cong. § 321(d) (reflecting conference committee's changes).

[90] *See* H.R. REP. NO. 106-970, § 321(d), at 69 (2000) (Conf. Rep.); *Id.* § 708, at 96; S. 3186, 106th Cong. §§ 321(d),708 (reflecting conference committee's changes).

[91] *See* H.R. REP. NO. 107-3, at 483, 485 (2001) (setting forth dissenting views of minority committee members); 147 CONG. REC. S2,034 (daily ed. Mar. 8, 2001) (reprinting letter from Prof. Elizabeth Warren, Reporter, National Bankruptcy Review Commission); *The Bankruptcy Reform Act of 2001: Hearing on S. 220 Before the S. Comm. on the Judiciary*, S. HRG. 107-195, at 44-45, 48 (2002) (testimony of Brady C. Williamson, Chair, National Bankruptcy Review Commission); *Bankruptcy Abuse Prevention and Consumer Protection Act of 2001: Hearings on H.R. 333 Before the H. Comm. on the Judiciary*, 107th Cong., at 357 (2001), *available at* http://commdocs.house.gov/committees/judiciary/hju71179.000/hju71179_0f.htm (last visited Nov. 3, 2005) (statement of Sen. Nadler).

[92] *See* NAT'L BANKR. CONFERENCE, ANALYSIS OF PENDING BANKRUPTCY LEGISLATION COMPARING H.R. 333 EAS (SENATE BILL) AGAINST H.R. 333 (HOUSE BILL), at 106, 151-52 (Sept. 2001), *available at* http://www.nationalbankruptcyconference.org/documents/Final%20Chart83101.pdf (last visited Nov. 13, 2005); NAT'L BANKR. CONFERENCE, DISCHARGEABILITY OF CORPORATE DEBT UNDER S.220 (107th Cong.), at 2, *available at* http://www.nationalbankruptcyconference.org/documents/DischargeofCorpDebt2.pdf (last visited Nov. 13, 2005); NAT'L BANKR. CONFERENCE, REPORT ON H.R. 2415, 106TH CONGRESS, 2D SESSION (H. REPT. 106-970), at iii, 5, 17 (2001), *available at* http://www.nationalbankruptcyconference.org/documents/Introduction.doc.pdf (last visited Nov. 13, 2005); *Bankruptcy Abuse Prevention and Consumer Protection Act of 2001: Hearings on H.R. 333 Before the H. Comm. on the Judiciary*, 107th Cong., at 391, 394, 396 (2001) (testimony of Ralph R. Mabey, National

those ultimately enacted in section 1141(d)(6).[93] The very existence of that provision, however, invites the same set of puzzled questions[94] that reflexively point toward *expansion* of the corporate discharge exceptions, as the legislative process producing that provision attests.[95] Section 1141(d)(6) is sure to foster endless misunderstandings (and even outright manipulation)[96] regarding the function of the corporate discharge in chapter 11.

Bankruptcy Conference), *available at* http://commdocs.house.gov/committees/judiciary/hju71179.000/hju71179_0f.htm (last visited Nov. 13, 2005).

[93] The initial bills introduced in both houses in the 107th Congress contained the same corporate non-dischargeability provisions that appeared in the 106th Congress legislation (*see supra* note 90) pocket vetoed by President Clinton. *See* S. 220, 107th Cong. §§ 321(d), 708 (as introduced, Jan. 30, 2001); S. 420, 107th Cong. §§ 321(d), 708 (as introduced, Mar. 1, 2001). The bill passed by the House also contained these corporate discharge exceptions. *See* H.R. 333, 107th Cong. §§ 321(d), 708 (as passed in House, Mar. 1, 2001). Amendments in the Senate, though, produced the more limited corporate discharge exceptions that ultimately became law in the 2005 amendments. This provision appeared in both bills passed by the Senate, as well as the conference report, and the modified version of the conference report agreed to in the House. *See* S. 420, 107th Cong. §§ 321(d), 708 (as passed in Senate, Mar. 15, 2001); H.R. 333, 107th Cong. §§ 321(d), 708 (as passed in Senate, Jul. 17, 2001); H.R. REP. NO. 107-617, § 321(d), at 73, 221 (2002) (Conf. Rep.); *Id*. § 708, at 103–04, 244; H.R. 5745, 107th Cong. §§ 321(d), 708 (as inserted in H.R. 333 and passed in House, Nov. 15, 2002).

Thereafter, the legislation in both the 108th and 109th Congresses contained the corporate discharge exceptions that ultimately became law in the 2005 amendments. *See* H.R. 975, 108th Cong. §§ 321(d), 708 (as introduced, Feb. 27, 2003, and as passed in House, Mar. 19, 2003); S. 1920, 108th Cong. §§ 321(d), 708 (as passed in House, Jan. 28, 2004); H.R. 685, 109th Cong. §§ 321(d), 708 (as introduced, Feb. 9, 2005); S. 265, 109th Cong. §§ 321(d), 708 (as introduced, Feb. 1, 2005, as passed in Senate, Mar. 10, 2005, as passed in House, Apr. 14, 2005, and as signed by President Bush, Apr. 20, 2005).

[94] Why only those fraud debts owing governmental units? Why only fraud debts? Why not all section 523(a) debts?

[95] Professor Picker's prescient remarks regarding the Commission's initial proposal for non-dishargeability of corporate tax fraud debts in chapter 11 remain apt: "This provision . . . could encourage the pursuit of additional exceptions." *The Business Bankruptcy Reform Act: Hearings on S. 1914 Before the Subcomm. on Administrative Oversight and the Courts of the S. Comm. on the Judiciary*, 105th Cong., 1998 WL 268198 (May 19, 1998) (testimony of Randall C. Picker, National Bankruptcy Conference).

[96] For example, in the rush to expand the corporate discharge exceptions in the 106th Congress, after the Commission's proposal opened the floodgates, Senator Levin offered an amendment to S.625 to provide that "the confirmation of a plan does not discharge a debtor that is a corporation from any debt that is (A) related to the use or transfer of a firearm . . . and (B) based in whole or in part on fraud, recklessness, misrepresentation, nuisance, negligence, or product liability." 145 CONG. REC. S14,160 (daily ed. Nov. 5, 1999) (Levin amendment No. 2685). As with the discharge exception for corporate tax fraud, proponents of this gun-debt discharge exception painted it as necessary to "close a gaping loophole" that prevents individuals from discharging debts for reckless injury, "such as debts incurred by the operation of a motor vehicle while legally intoxicated," but "that allows gun manufacturers, distributors, and dealers . . . to use bankruptcy to escape liability." 146 CONG. REC. S183 (daily ed. Feb. 1, 2000) (statement of Sen. Kennedy); *see also id*. (statement of Sen. Durbin) ("By adopting [this amendment], we will further the goal of reducing abuses of the bankruptcy system. Remember, that is why this debate is under way."). One suspects, though, that the objective of the proposed gun-debt discharge exception was simply to *prevent* gun manufacturers, distributors, and dealers subject to significant product liability judgments from reorganizing as operating entities, thereby, forcing liquidation of their businesses. *See id*. at S181 (statement of Sen. Hatch) ("I think this amendment is part of an effort to put the firearms industry out of business."); *id*. at S185 (statement of Sen. Grassley) (This amendment is merely an effort to drive all segments of American industry involved with guns out of business . . . .").