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## AVOIDING THE EX POST FACTO SLIPPERY SLOPE OF *DEER PARK*

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In *United States v. Energy Resources Co.*, [1] the Supreme Court held that a bankruptcy court has the power to order the Internal Revenue Service ("IRS") to apply current or future payments made under a rehabilitating Chapter 11 plan to particular tax debts, thus denying the IRS the ability to apply the payments as it saw fit. [2] Although the Ninth Circuit's later decision in *IRS v. Creditors Committee* (*In re Deer Park, Inc.*) [3] typically is seen as extending the *Energy Resources* rule to liquidating Chapter 11 plans, [4] it also extends the doctrine in another direction. The decision upholds the bankruptcy court's power to act *ex post facto* in reaching back and designating payments which have already been made to the IRS after the Chapter 11 plan has been substantially completed. [5]

This Article contends that bankruptcy courts have no power to grant designation orders *ex post facto*. It argues that *Deer Park* was wrong not just in extending the *Energy Resources* rule to a Chapter 11 liquidation case, [6] but also by doing so *ex post facto*. It is suggested that the *Energy Resources* rule is properly applied only when the designation order is proposed *before* a Chapter 11 plan is approved or, at the very latest, before the plan has been substantially completed. This Article also suggests that *Deer Park* illustrates the weakness of a key underlying premise of the *Energy Resources* opinion with the result that designation orders should be cautiously issued even in rehabilitation cases.

Part I explains the interplay of the relevant tax and bankruptcy laws surrounding this issue. Part II analyzes the Supreme Court and court of appeals *Energy Resources* opinions and their progeny to demonstrate how the rule laid down requires courts to balance the bankruptcy policy of debtor rehabilitation against the bankruptcy policy of maximizing the payment of tax claims. Part III critiques the basis of *Deer Park*'s extension of the *Energy Resources* rule to a designation order made after a Chapter 11 liquidation had already been completed and all payments had been made.

### I. Relevant Tax and Bankruptcy Law

The Internal Revenue Code ("IRC") imposes on several groups of persons the responsibility to collect, account for and pay over to the government various taxes imposed on other persons. [7] These taxes are known as "trust fund" taxes because the money collected is deemed to be held in trust for the United States. [8]

Two of the most important trust fund taxes are the income and social security withholding taxes. [9] The IRC makes every employer responsible for collecting employees' income and social security taxes, and paying the taxes so collected to the government on a quarterly basis. [10] If the employer fails to properly pay over these withheld amounts to the government the Treasury suffers a loss because employees are given credit for taxes withheld regardless of whether the money actually reaches the government's coffers. [11] The trust fund taxes are in addition to, and should not be confused with, the taxes imposed directly on the employer by section 3401 of the IRC for the "privilege" of employing workers. [12] These latter direct (or nontrust fund) taxes, which correspond in amount and purpose to the taxes imposed on each employee by the Federal Insurance Contribution Act ("FICA") [13] and Federal Unemployment Tax Act ("FUTA"), [14] are reported on the same form (Form 941) as, and paid over to the government at the same time as, the trust fund taxes collected by employers. [15]

To help ensure that employers properly pay over their trust fund tax obligations, section 6672 of the IRC provides that the IRS may impose a penalty on any "person"−which term can include individual employees as well as the employer−who, "under a duty" to collect a trust fund tax, "willfully fails to collect such tax, or truthfully account for and pay over such tax." [16] The penalty amount is 100% of the amount not paid. Although now referred to as the Trust Fund Recovery Penalty ("TFRP"), for a long time it was known as the "100% penalty." [17] The longstanding practice of the IRS, however, is to use the TFRP merely as a tool to collect the full amount of the taxes withheld but not paid rather than to impose a penalty. [18]

In considering issues surrounding the TFRP, it is critical to understand that the liability for withholding taxes under sections 3102 and 3402 [19] of the IRC is separate and distinct from the liability imposed by section 6672. [20] As a consequence, the government may look not only to the employer to satisfy the withholding tax obligation (either pursuant to the employer's original withholding liability or pursuant to its section 6672 liability), but also may look to those officers and employees who are shown to have had sufficient responsibility ("responsible persons") so as to bring them within the scope of section 6672's operation. [21] It is not necessary for the IRS to wait until the employer fails to remedy its delinquency before collecting from these responsible persons. [22] Specifically, when an employer goes into bankruptcy, the IRS may proceed to collect from responsible persons without waiting to see whether the employer will be able to make any payments in the bankruptcy case. [23] The automatic stay does not prevent section 6672 recovery precisely because the IRS is attempting to collect the responsible person's liability, not the employer's. [24]

As a consequence of the IRS's use of section 6672 as a collection tool and its ability to collect the TFRP from the employer or any responsible person, [25] any payment made by the employer that is applied to the trust fund taxes will reduce the exposure of any potential responsible persons. [26] Likewise, any amounts recovered from a responsible person will reduce the liability of the employer and any other responsible person. [27] These consequences coupled with the fact that both trust fund and direct taxes are reported by the employer on its Form 941 assume especial importance when an employer makes only a partial payment of its 941 liability. In that partial payment situation it may make a difference both to the potential responsible persons' liability and to the IRS's ultimate ability to collect all amounts due whether the IRS applies the partial payment to the trust fund taxes owed or to the direct taxes owed. [28]

In the nonbankruptcy context, employers may direct the IRS to apply a partial payment in satisfaction of their trust fund liabilities before applying the payment to their nontrust fund liabilities. The IRC usually does not say who, as between the taxpayer and the IRS, has the power to apply partial payments to which of several taxes owed. To address this issue courts have imported the common law rules regarding voluntary and involuntary payments into the tax law. [29] Thus, a taxpayer is allowed to designate how a voluntarily made payment should be applied, so long as "specific written instructions" accompany the payment. [30] On the other hand, involuntary payments, as well as undesignated voluntary payments, may be applied "as the IRS sees fit," [31] and to "whatever liability" the IRS chooses. [32]

Since, in the normal course of business, responsible persons usually do not cause the employer to direct tax payments to be applied first to trust fund liabilities (though to do so might be prudent even as a matter of routine), when an employer goes into bankruptcy the responsible person's potential exposure can increase dramatically. [33] Though the IRS's policy statement on the TFRP provides that no attempt to collect from the responsible person will be made if the employer is operating under an approved bankruptcy plan and is adhering to the plan's provisions, [34] the statement is silent as to what the IRS may do before the plan is approved or where there is no plan to be approved, as in a Chapter 7 proceeding. Thus, the responsible persons have a great incentive to make sure that any payments made during the employer's bankruptcy are applied first to trust fund taxes so as to reduce or eliminate their potential section 6672 exposure. The IRS, however, in order to maximize revenue collection, has a great incentive to apply all payments received in bankruptcy first to nontrust fund taxes, so that the trust fund portion may still be collected from the responsible persons outside of the bankruptcy context if the employer cannot provide full payment. It is this conflict which has produced the series of cases culminating in *Energy Resources*.

## II. The *Energy Resources* Decision and Its Progeny

Prior to the Supreme Court's decision in *Energy Resources*, debtors tried in vain to compel the IRS to allocate payments made in bankruptcy first to trust fund obligations of the debtor. Four of the five circuits to decide this issue

held that payments made pursuant to a bankruptcy liquidation or plan of reorganization were involuntary and therefore the debtor was not entitled to control the payments. [35] The basis for these four decisions was that since the debtor always must answer to the bankruptcy court, which has broad powers of supervision over the debtor, all payments from a debtor in bankruptcy are, ultimately, the result of court order and so are involuntary. [36] Therefore, under the common law rules, the IRS and not the debtor had the ability to control the application of payments in bankruptcy.

The First Circuit and, ultimately, the Supreme Court used this same reasoning in *Energy Resources*, however, to conclude that those broad powers of supervision included the power to compel the IRS to honor the debtor's allocation designation. [37] *Energy Resources* was a consolidation of two cases, involving two corporations which had filed petitions for reorganization under Chapter 11. [38] In the first case, the Chapter 11 plan approved for Newport Offshore, Ltd. specifically provided that any payments for employment taxes first would be applied to extinguish the trust fund portion of the employer's liability. [39] The IRS's objection to that plan provision was the matter that reached the Supreme Court. [40] In the second case, the plan approved for Energy Resources, Inc. did *not* contain such a provision, but when the trustee sent in the first payment, he made a specific request that the money be applied to the trust fund liability. [41] The IRS refused and the trustee petitioned the bankruptcy court to enforce his request; the trustee's petition was granted. [42] Thus, the controversy in the second case was over the propriety of the bankruptcy court making the "specific written request" instead of the debtor. [43]

These two cases were consolidated for appeal because they both presented the broader issue of whether bankruptcy courts have any power to interfere with the IRS's application of payments made in bankruptcy. [44] The First Circuit affirmed both bankruptcy court orders. [45] The Supreme Court, in a cursory opinion, agreed. [46] The Court held that a bankruptcy court has the discretionary power to "order the IRS to apply tax payments to offset trust fund obligations where it concludes that this action is necessary for a reorganization's success." [47] The Court found that this power, which it characterized as the traditional "broad authority to modify creditor−debtor relationships," [48] was codified in two statutory provisions. First, under section 105 of the Bankruptcy Code, a court could "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions" of the Bankruptcy Code. [49] Second, and specifically as to Chapter 11 plans of reorganization, section 1123(b)(6) allowed a bankruptcy court to approve any Chapter 11 plan provision which was "not inconsistent with the applicable provisions of . . . [the Bankruptcy Code]." [50]

The Court recognized that the equitable powers contained in Code sections 105 and 1123 could be limited both by Bankruptcy Code provisions as well as other federal statutes. [51] The IRS argued that the designation order transcended both bankruptcy and nonbankruptcy law. [52] The IRS asserted that the order was inconsistent with the Bankruptcy Code because it decreased the possibility that the IRS's tax claim would be paid in full within six years, as required by Code section 1129(a)(9)(C), [53] and that the order was inconsistent with section 6672 of the IRC because it deprived the IRS of an alternate source of collecting the penalty. [54] The Court's response was short and to the point: The IRS wanted more than the statutes allowed. [55] The Bankruptcy Code's guarantee of full payment in six years applied only if the reorganization was successful. [56] The designation order decreased the overall likelihood of the taxes being collected solely because it cut off the IRS's ability to collect taxes from responsible persons, which would be unpaid only if the plan failed. In that way, the designation order simply shifted the *risk* of plan failure from the responsible persons to the IRS. It did not, by itself, deny the IRS its taxes. Thus, according to the Court, the IRS was impermissibly seeking "an added protection not specified in the Code itself." [57] Likewise, the Court noted that section 6672 did not concern itself with the collection of nontrust fund taxes; it simply helped ensure that the government collected trust fund taxes. [58] The Court noted that the designation orders obviously did not violate section 6672 because they actually "*require* the Government to collect trust fund payments before collecting nontrust fund payments." [59]

Once it found that the bankruptcy courts' orders had not transgressed any bankruptcy or nonbankruptcy law, the Supreme Court ended its perfunctory analysis by laying down this rule: A bankruptcy court has the discretion to "order the IRS to apply tax payments to offset trust fund obligations where it concludes that this action is necessary for a reorganization's success." [60] The Court did not say how this conclusion was to be determined. However, the First Circuit's well−reasoned opinion did provide guidance, [61] which subsequent courts have imputed to the Supreme Court's opinion. [62] Judge Breyer, writing for the panel, summed up the analysis this way:

> [T]he bankruptcy court should make the following inquiry: upon consideration of the reorganization plan as a whole, in so far as the particular structure or allocation of payments increases the risk that the IRS may not collect the total tax debt, is that risk nonetheless justified by an offsetting increased likelihood of rehabilitation, *i.e.*, increased likelihood of payment to creditors who might otherwise lose their money? [63]

The First Circuit derived this guidance from bankruptcy law's continual struggle to balance the inherent tensions between creditors' interests in full payment of debts and debtors' interests in fresh starts. [64] Specifically, both protection of the revenue and debtor rehabilitation are worthy but sometimes inconsistent goals which the Bankruptcy Code attempts to mediate. [65] On the one hand, the Bankruptcy Code, in general, protects the government's ability to collect the revenue. [66] On the other hand, Chapter 11 attempts to allow debtors a reasonable opportunity to continue in business. [67] Congress specifically recognized that compromises would be required between these competing interests:

> In a broad sense, the goals of rehabilitating debtors and giving equal treatment to private voluntary creditors must be balanced with the interests of governmental tax authorities who, if unpaid taxes exist, are also creditors in the proceeding. [68]

The balancing test articulated by the First Circuit (and impliedly adopted by the Supreme Court) contains a key presumption: Designation orders are legitimate tools to improve the debtor's chances at rehabilitation because they will encourage participation by key managers in the rehabilitation efforts. [69] Only if such an order were a legitimate tool could it weigh in the balance between debtor rehabilitation and revenue protection.

In applying this balancing between interests of the debtor and the government, circuit courts have read *Energy Resources* narrowly, limiting the discretion of the bankruptcy courts. For example, the opinion does not say that bankruptcy courts may approve designation orders *only* when "necessary" or *only* when "for a reorganization's success." [70] The opinion simply affirms that when a lower court has found that the designation *is* necessary the court may order the designation. [71] Moreover, the statute on which the decision rests authorizes the bankruptcy courts to issue orders whenever "necessary *or appropriate*." [72] Since it is this statute which provides the authority, one might conclude that any court which finds it merely "appropriate," short of necessary, would be affirmed. Nonetheless, subsequent courts have read the *Energy Resources* opinion as allowing bankruptcy courts to designate tax payments only where such a designation is both "necessary" and essential "for a reorganization's success." [73] Likewise, most courts have confined the *Energy Resources* rule to those cases in which the designation is found to be vital to aid the *rehabilitation* of the debtor and have rejected the application of the rule to either Chapter 7 or Chapter 11 liquidations. [74]

Illustrative of these decisions and their application of the *Energy Resources* balancing test is the well−reasoned opinion of the Third Circuit in *United States v. Pepperman*, [75] which held that the bankruptcy court has no authority to order the IRS to designate payments in a Chapter 7 liquidation. [76] *Pepperman* concerned the Chapter 7 bankruptcy of Sorensen Industries, Inc. ("SI") and its owner, Keith Sorensen ("Sorensen"). [77] The IRS had imposed the TFRP on Sorensen for SI's unpaid prepetition trust fund taxes. [78] Pepperman, the trustee for both Sorensen and SI, caused SI to remit part of its 941 taxes to the IRS (approximately $34,000) and, simultaneously, asked that Sorensen's TFRP liability be reduced by that amount. [79] The IRS refused to do so because the amount remitted was insufficient to satisfy SI's nontrust fund 941 liability and the IRS, as explained above, had every incentive to apply the payment to SI's nontrust fund liability. [80] Pepperman then moved the bankruptcy court to reduce Sorensen's TFRP, and the bankruptcy court, reading *Energy Resources* as allowing it to rely on Bankruptcy Code section 105 to make any order necessary *or* appropriate, held that it had the equitable power to grant the trustee's motion. [81] The District Court affirmed, using similar reasoning. [82] Neither the bankruptcy court nor the district court engaged in any type of balancing analysis. Instead, each relied on the equitable authority which the Supreme Court said the bankruptcy court had both as a matter of tradition and pursuant to Bankruptcy Code section 105. [83]

The Third Circuit reversed. [84] It held that the proper analysis to follow is to balance "the goals of revenue protection and debtor rehabilitation." [85] Under that analysis, while recognizing the force of the *Energy Resources* rationale in Chapter 11 reorganization contexts, the court held that a different balance must be struck in a liquidation context because "designation of tax payments cannot aid the debtor's reorganization efforts." [86] The court recognized that although it was appropriate in the reorganization context to place the *risk* of rehabilitative failure on the IRS rather

than on the responsible persons, it was not appropriate in the liquidation context. [87] There was now a certainty of no rehabilitation and it would be contrary to the preferred status given tax debts in the Bankruptcy Code to preclude the IRS from collecting those tax debts by forcing it to apply the corporate payments to the trust fund taxes. [88] For example,

> [a]lthough Sorensen's creditors could be benefitted by a reduction in the IRS's tax claim against him, such benefits would be secured at the expense of the IRS, a preferred creditor. Were that effected, the general rule that the government is entitled to priority over general creditors for the payment of section 6672 liability would be weakened. [89]

Here, the *Pepperman* court implicitly rejected the idea that the interests of creditors, in general, to maximize their claims, could properly be weighed against the interest of a specific creditor whose claims were preferred. [90]

Although *Pepperman* concerned a Chapter 7 liquidation, the court's reasoning focused on the liquidation aspect of the bankruptcy, not the particular chapter under which the liquidation took place. [91] Thus, the court made no distinction between cases concerning Chapter 11 liquidation and those involving Chapter 7 liquidation in citing precedent for its proposition that "[t]he vast majority of courts that have addressed the issue of the scope of the *Energy Resources* decision have declined to extend its application beyond the Chapter 11 reorganization context." [92] Moreover, the court recognized that in some liquidation situations, even in Chapter 7, the bankruptcy court's authority to issue a designation order would be upheld, but noted that "[t]he underlying premise of such authority must be a finding that such an order is necessary or appropriate to carry out the provisions of the Bankruptcy Code." [93] In this manner, the court analyzed the broader implications of *Energy Resources* in liquidating versus nonliquidating bankruptcies and correctly noted that, unlike in the rehabilitative context, the concerns of the debtor which could possibly outweigh the interests of the government simply were not present in the liquidating context. [94] Thus, the court implicitly rejected the notion that general creditor claims could offset the preferred status of tax claims.

The vast majority of courts have used reasoning akin to that articulated in *Pepperman* to restrict the Supreme Court's *Energy Resources* balancing test to those situations in which a proposed designation is necessary to the debtor's rehabilitation. [95] The question of when and whether a proposed designation order is necessary is properly one of fact, but if there is no proposed rehabilitation, courts have almost uniformly held that the *Energy Resources* balancing test, as a matter of law, resolves in favor of the government. [96] The most notable exception to this trend is the Ninth Circuit's two to one panel opinion in *In re Deer Park, Inc.*. [97]

III. The *Deer Park* Decision

Deer Park, Inc. ("Deer Park") operated a ski area in the Lake Tahoe region of California. [98] Upon filing Chapter 11 in December 1983, [99] the IRS filed claims totaling $94,202.31 (of which $72,669.13 were secured), the majority of which stemmed from Deer Park's failure to pay trust fund taxes. [100] At the time Deer Park failed to pay these trust fund taxes, Gerald Stoll was the president of Deer Park and was the person responsible for paying the trust fund taxes. [101] The IRS eventually assessed the TFRP against Stoll in 1990. [102]

Under Deer Park's Chapter 11 plan, proposed by its Creditors Committee, Deer Park was to cease operations and liquidate its assets. [103] Specifically, the plan called for all assets (consisting almost entirely of Deer Park's realty) to be sold to Alpine Meadows ("Alpine"), a neighboring ski operation, for $275,000, plus interest, to be paid out over a three year period. [104] The plan provided that the property would be sold to Alpine free and clear of all tax liens and that the liens would be transferred to the proceeds of the sale. [105] In addition, the plan provided that the IRS's claims were to be paid in full out of the Alpine purchase money. [106] The plan also contained two contingency clauses. First, since the sales price reflected Alpine's planned use of the Deer Park property as merely a parking and storage area, the plan also provided that if Alpine resold the Deer Park property within five years for more than the purchase price, Deer Park would get half of the excess. [107] In addition, if Alpine reopened Deer Park as a separate ski area within ten years, Alpine would pay a certain additional sum. [108] Since Deer Park's leased ski lifts had been repossessed by their owner prior to the bankruptcy in 1983, this latter possibility, however, was remote at best, and was discounted by the Creditors Committee in both its Disclosure Statement [109] and in its First Amended Plan of Reorganization. [110]

The Chapter 11 plan was approved in October 1985. [111] In December 1986, the bankruptcy court approved a payment order for the priority tax claims to be paid out over a three year period. [112] Alpine paid its last installment, and the IRS received its last payment, in 1988. [113] Due to an administrative error, however, the December 1986 payment order listed the IRS's claims as being only $72,591.02, instead of the correct amount of $94,202.31, and so the claims were not paid in full but were underpaid by almost $22,000. [114] In June 1990, the IRS notified Stoll that it intended to collect the shortfall from him pursuant to the previously assessed TFRP. [115] One month later, the Creditor's Committee moved the bankruptcy court to modify the 1986 payment order so as to require the IRS to apply the underpayment first to its trust fund tax claims. [116] Doing so would have left no trust fund taxes to be collected and thus would have eliminated Stoll's personal liability. The IRS, however, would still be out that same $22,000.

Over the IRS's objection the bankruptcy court granted the Creditors Committee's motion. [117] Both the Bankruptcy Appellate Panel ("BAP"), by a unanimous decision, [118] and the circuit court, by a split decision, affirmed. [119] In so doing, these courts extended *Energy Resources* in two directions. First, the courts held that a designation order in a liquidation case under either Chapter 11 was not *per se* invalid. [120] Second, the courts upheld a designation order *ex post facto*; the designation order having been requested after the Chapter 11 liquidation plan had been completed in every meaningful sense. [121] Each of these extensions shall be critiqued in turn.

A. Designation Orders In Liquidation Cases

Despite its victories in other circuits, the IRS was unable to convince the *Deer Park* courts that the *Energy Resources* holding should *never* apply to a liquidating plan. The central reasoning of the BAP was that "[s]uch a broad statement fails to recognize that a debtor's continuing participation in a planned, orderly liquidation may in fact be necessary to bring about the maximum recovery for the creditors, as opposed to the amount realized from a forced sale." [122]

The BAP emphasized that, not only was a Chapter 11 liquidation technically a "reorganization" within the meaning of Chapter 11 and thus arguably within the rule laid down in *Energy Resources*, but that it was, in reality, closer to a true Chapter 11 rehabilitative reorganization than it was to a Chapter 7 liquidation for two reasons. [123] First, "Chapter 11 allows the debtor in possession, one who is presumably more familiar with the assets of the debtor's organization and its respective values, the ability to plan for an orderly divestiture of the assets." [124] Second, even a liquidating Chapter 11 plan had to conform to the same statutory requirements of any other Chapter 11 reorganization. [125] Therefore, the BAP concluded that the bankruptcy court had the authority to issue the amended payment order requiring the IRS to apply any payments received under the plan to the trust fund taxes. [126] The Ninth Circuit's conclusory opinion did not add significantly to the BAP's analysis. [127]

At first blush, the rejection of a *per se* rule against designation orders in liquidation cases may seem entirely unobjectionable. After all, a Chapter 11 liquidating plan is subject to the same requirements as any other Chapter 11 plan, including the requirements that tax claims be paid within six years [128] and that the IRS receive more for its impaired claims, if any, than it would receive under a Chapter 7 liquidation. [129] It might seem, therefore, that the *Energy Resources* justification for balancing would still apply. That is, nowhere does the Bankruptcy Code prohibit the bankruptcy court from allocating the *risk* of plan failure. To the extent that courts may legitimately shift the risk of plan failure from one group (the responsible persons), to a single creditor (the IRS) in the rehabilitation context, the bankruptcy court also may legitimately shift the risk of plan failure from one group (other creditors) to another (the IRS) in the liquidation context, if circumstances warrant. Courts would not be shifting actual dollars, just the risk.

Further analysis, however yields a different conclusion. A closer look at the *Deer Park* opinions reveals that the courts actually use a different balancing test than the one adopted in *Energy Resources* and that they shift more than merely the risk of plan failure. While the goal of revenue protection remains the same, the *Deer Park* courts substitute the goal of maximized creditor recovery for the goal of debtor rehabilitation. [130] These are vastly different goals. Liquidation, no matter how well executed, does not benefit the debtor. [131] A better liquidation−assuming that is what Chapter 11 liquidations actually achieve−only benefits a limited class of creditors, chiefly those holding priority claims. In contrast, a successful rehabilitation not only directly benefits the debtor, but also benefits the entire range of creditors, including equity holders, as well as an even broader range of noncreditors. [132] It is *this* benefit of reorganization−that "[i]t is more economically efficient to reorganize than to liquidate, because it preserves jobs and assets" [133] −which is the driving force behind Chapter 11, [134] and which is absent in the liquidation context, regardless

of what bankruptcy chapter the liquidation proceeds under.

In a very real sense, a liquidating plan is simply a rehabilitating plan which has already failed; there will be no "fresh start" regardless of whether or not the liquidating plan succeeds in paying off all the creditors. The plan cannot possibly succeed in the sense that underlies the Supreme Court's holding in *Energy Resources*. Thus, the interests that lie in the scales in *Deer Park* are the same interests that competed in *Pepperman* and, therefore, the same result should obtain; designation orders should not be allowed. The BAP's observation that a Chapter 11 liquidation plan is like a Chapter 11 rehabilitation plan because both are subject to the same requirements that tax claims be paid within six years and that the IRS receive more than it would under Chapter 7 misses this point. For purposes of evaluating the propriety of allowing a bankruptcy court to direct how the IRS must apply plan payments, a Chapter 11 liquidation is far more like a Chapter 7 liquidation than it is a Chapter 11 rehabilitation because the interests to be compared−maximized recovery for a group of creditors versus maximized recovery for the government−are identical. The BAP's observation is merely another way of saying that the risk to the government's interest is the same in both liquidating and rehabilitating plans. That ignores the dramatic change in the other side of the scale.

Further, as *Deer Park* itself illustrates, a Chapter 11 liquidation may in practice look more like a Chapter 7 liquidation than a Chapter 11 rehabilitation, even from a creditor's perspective. The *Deer Park* debtor sold its main asset, land, for its parking and storage value, *not*, as theory might predict, for its "going concern value." [135] Assuming that the designation order had been requested up front, it is still difficult to imagine how the participation of the debtor's president added value to the sale or made the difference between Alpine buying the property or not. The contingency clauses appear to be more in the nature of safeguards against the purchaser making a lowball offer. As Judge Ferguson noted in his dissent, it is difficult to imagine any ski area operating once the ski lifts had been removed. [136] In the disclosure statement, the Creditors Committee repeatedly cautioned that there was no indication or assurance that bonus payments would be generated by Alpine either reselling the property within five years or reopening the property as a ski area within ten years. [137]

Nor is it clear how often proposed Chapter 11 liquidation plans even attempt to pay off tax claims within six years. For example, in *In re Laminating, Inc.*, [138] the debtor requested the designation of payments in its First Amended Plan of Liquidation. [139] The debtor owed over $255,000 in taxes, interest and penalties, yet was expected to realize only about $100,000 from the sale of its assets, so that, the IRS would receive partial payment and the remaining debtors would receive nothing. [140] Concluding that the designation provisions in the plan "serve only to relieve . . . [the president and sole shareholder of the company] of his personal liability and are unnecessary to the success of the plan," [141] the court rejected the proposed plan.

The *Laminating* court's characterization of the proposed designation orders as being designed solely to relieve the responsible person of personal liability [142] points up another danger in allowing designation orders, even in rehabilitating plans. Even if some benefit accrues to the debtor, the greatest benefit of a designation order is always to the responsible persons, who are thereby effectively "discharged" of personal liability. [143] As a general rule, while bankruptcy courts can discharge the debtor from its debts, they cannot discharge third parties who may be jointly liable on those same debts. [144] Thus, while the Bankruptcy Code is concerned with the debtor and its creditors, it is not concerned with third parties except to the extent that their welfare affects the debtor's welfare. [145] As a practical matter, however, it is difficult to separate the interests of the debtor from the interests of the responsible persons. [146] Thus, the responsible persons' interests act as a "thumb in the balance," usually in favor of allowing designation. Naturally, if the responsible persons are perceived by the bankruptcy court as being bad actors, the thumb goes on the other side. The point, however, is that whichever side of the scale the bankruptcy court puts its self−perceived equitable thumb, its placement becomes far more outcome−determinative in the liquidation context because of the vastly weaker concerns on the debtor's side of the balance.

For these reasons, the better rule is that designation orders should not be allowed in liquidation cases, regardless of which bankruptcy chapter governs the liquidation. Care must be taken, however, in determining what constitutes a true liquidation. A Chapter 11 plan which is, in form, a liquidation may still be, in substance, a reorganization. An example is the case of *In re Flo−Lizer*, [147] in which the form of the Chapter 11 plan was a liquidation but the substance was a reorganization. [148] Flo−Lizer's Third Amended Plan (the "Plan") proposed that the business cease operating as Flo−Lizer and that most of its assets and about two−thirds of its liabilities be transferred to a new entity

called Flo−Ag, Inc. [149] A close examination of the Plan shows it to be similar to the plan under consideration in the *Energy Resources* case itself [150] and thus quite different from the *Deer Park* plan. [151] Although the debtor ceased to operate under its own name, the Plan called for the principals of the debtor to form a new company and transfer the bulk of the debtor's assets *and* obligations to it. [152] Similarly, in *Energy Resources*, part of the debtor was liquidated and the remaining part merged with a separate company to form a new entity. [153]

In *Flo−Lizer*, the Plan also provided the debtor with the authority to make any modifications necessary "to qualify as a 'tax free G reorganization' under the Internal Revenue Code." [154] Further evidencing the rehabilitative efforts of the debtor and its principals is the fact that the two responsible persons contributed significant personal assets after the Plan was approved. [155] In order for the Plan to work, the largest bank creditor, American Security Bank, had to approve the transfer of assets to the newly created company. [156] American Security Bank refused to approve the transfer unless certain environmental problems were addressed. In response, one of the responsible persons contributed approximately $150,000 [157] and the other responsible person contributed a personal asset worth $350,000 to satisfy American Security Bank and allow the transfer. [158] In effect, Flo−Lizer continued to operate. Its trade creditors and customers continued to do business with the same employees at the same locations, and although the old corporate entity had been liquidated and a new corporate entity formed, the principals of the old company were also the principals of the new company. [159] Therefore, the goal of the liquidation plan was, in fact, to continue the business.

In the *Flo−Lizer* situation, where the responsible person contributes hard cash or cash equivalents without taking a superpriority position under Bankruptcy Code section 364, [160] it may be proper to allow the court the discretion to issue a designation order. The decision faced by the responsible person is whether to contribute money to a plan which might fail and thus risk losing the money which might otherwise be saved in order to pay his or her personal section 6672 liability. [161] To induce that infusion of cash while not losing the availability of Bankruptcy Code section 364 [162] for other potential lenders, it may indeed be necessary to assure the responsible person that the trust fund portion of the debtor's liability will be satisfied first. [163] This, however, would be the limited exception to my proposed general rule that requests for designation orders in Chapter 11 liquidations be disallowed as a matter of law.

B. Ex Post Facto Designation Orders

Having rejected the argument for a *per se* rule prohibiting courts from ordering the IRS to designate payments to trust fund tax liabilities in Chapter 11 liquidations, the *Deer Park* courts then proceeded to extend *Energy Resources* in a second direction by upholding the issuance of a designation order in the case of a Chapter 11 plan *which had been completed* at the time the designation order was sought. Here, the two courts diverged somewhat on their justification for this second extension. Each court highlighted a different rationale for allowing the bankruptcy court to make an *ex post facto* designation order.

The BAP emphasized that it was permissible because Stoll's *past* services under the plan had been given without compensation, based on an understanding with the Creditors Committee that his personal liability for trust fund taxes would be eliminated. [164] Stoll's initial participation was based on his belief that his potential tax liability would be entirely satisfied by the plan payments to the IRS. [165] This was his only compensation. [166]

In contrast, the Court of Appeals decided that the plan had not yet been "completed" because there were two years yet to run on the ten year contingency clause:

> [T]he possibility of reopening Deer Park for downhill skiing existed and that was a fundamental part of the Plan approved by the creditors. . . . Stoll, because of his experience with Deer Park and his contacts . . . and his commitment to the fulfillment of the contingencies of the Plan, was the person most likely to make this part of the Plan succeed. We conclude that the bankruptcy court did not clearly err in finding that Stoll's assistance was essential to the success of the Plan. [167]

This second extension of *Energy Resources* is even more clearly wrong than the first. Neither rationale withstands close scrutiny. The *Energy Resources* rule is that a bankruptcy court may approve designation orders "where it concludes that this action is necessary for a reorganization's success." [168] This rule is necessarily forward−looking. By stressing that the government is protected by the bankruptcy court's judgment that the plan satisfies Bankruptcy Code

section 1129, including the requirement that it *will* pay off tax claims within six years, [169] the Supreme Court clearly indicated that what is needed is a plan that *will* succeed. [170] This ultimate judgment call subsumes two causal links: (1) but for the participation of the responsible persons the plan will not succeed, [171] and (2) but for the designation order the responsible person would not participate. [172]

In *Deer Park*, as in any other *ex post facto* situation, neither causal link existed. First, the plan had failed. [173] This was not a case of the bankruptcy court shifting the *risk* of plan failure. It was a case of the bankruptcy court shifting actual loss. If a plan has already failed, there cannot logically be a finding that a designation order is necessary for its success. Nothing remains to go on the debtor's side of the scale−or the maximized liquidation side−except for the goal of "discharging" the personal liability of the nondebtor responsible persons, which is not a legitimate goal of the bankruptcy proceeding. On the revenue protection side of the scale, however, plan failure means, by definition, that the tax liabilities remain unsatisfied after all payments have been made. [174] Thus, in *Deer Park*, all payments had been completed and the IRS had not been fully paid. [175] It would defy logic for any court to find that Stoll's participation was necessary for the success of a plan which had already failed. Likewise, since Stoll had *already* given his efforts, without the benefit of a designation order−which was entirely reasonable since it was obvious that sufficient proceeds existed to satisfy the debtor's tax liabilities in full [176] −it would be impossible for a court to have found that a designation order was necessary to have ensured his participation. [177]

The BAP thought Stoll should be rewarded for his participation because he had an understanding with the Creditors Committee that all trust fund taxes would be paid and that he participated on that basis. [178] This rationale contains two serious flaws. First, there may well have been *some* sort of understanding but, most likely, only an understanding on the part of all concerned that *all* tax claims would be paid. There were sufficient funds for that to happen. [179] Nothing in the record indicates that the Creditors Committee's administrative mistake which resulted in the underpayment of the tax claims was foreseeable. As Judge Ferguson pointed out in his dissent from the Ninth Circuit's opinion, the record was devoid of evidence, except for Stoll's self−serving declaration which was untested by cross−examination, that anyone gave any thought to which particular tax claims the IRS would first apply the payments made to it. [180] The second flaw in this reward rationale is that, as previously stated, [181] even if Stoll's "understanding" did exist, his participation clearly could not have been necessary to the success of a plan which already had failed.

The reward rationale also has disturbing implications for the rationale used in *Energy Resources*: That designation orders increase a responsible person's willingness to continue working for the debtor and for the success of the plan. [182] My intuition leads me to the opposite conclusion. By removing the threat of personal liability in the event of plan failure, the responsible person is under less pressure to ensure the plan's overall success. To the extent that the responsible person can make a difference, the incentive to continue making that difference once the corporate trust fund liabilities have been paid off is lost. [183] *Energy Resources* and other cases have viewed the designation order as somewhat of a carrot, perhaps in lieu of compensation, whereby the debtor can pay for the responsible person's services. [184] Following this reasoning, a bankruptcy court could absolve a responsible person of his or her surety obligations, discharge a partner of his or her personal liabilities, or otherwise do *anything* that it deems "necessary or appropriate" to secure those necessary services, so long as no specific provision of the Bankruptcy Code was directly violated. Focusing on the carrot−like aspects of designation orders makes it easy to overlook that they are not intended to benefit the responsible person, but rather they are intended to benefit the debtor and unsecured parties. [185] As discussed above, it becomes all too easy to confuse the debtor with the responsible person. It should be equally legitimate to view the denial of a designation order as a stick, giving the responsible person more incentive to work for the success of the plan by making him or her directly financially responsible. If a designation order is denied, then plan failure would make neither the responsible person nor the IRS worse off than before bankruptcy, but if the designation order is granted, then plan failure puts the IRS in a significantly worse position than before bankruptcy.

Apparently recognizing the flawed logic of the *Deer Park* BAP's reward rationale, the Ninth Circuit stressed instead that Stoll's participation was still necessary for the *future* success of the plan because there were still two years remaining on the ten year contingency event−that Alpine would use Deer Park as a ski area and generate bonus payments. [186] This rationalization completely twists the facts of the case. First, the bankruptcy court made no findings of fact that Stoll's participation was necessary for the success of the contingency. Second, the court likewise made no findings from which one could conclude that either this contingency, or the five−year contingency, [187] were part of the bankruptcy court's consideration of Bankruptcy Code section 1129. Third, the ten−year contingency was inherently

too remote and speculative to serve any legitimate role in the bankruptcy court's section 1129 determination. [188] It did not pretend to be an integral part of the liquidation plan; the Ninth Circuit made that up. [189] If it had been essential to the plan, this would have been a rehabilitation plan, and not a liquidation plan. In trying to build facts upon which to rest its decision, the Ninth Circuit only exposed the inherent weakness of its true holding.

Conclusion

The contrast between the findings required by *Energy Resources* and *Deer Park* illustrates the distance between the opinions and the essential problem with the latter's holding. Under *Energy Resources*, a bankruptcy court must find that the designation order *will be* necessary to the future success of the plan. Under *Deer Park*, however, a bankruptcy court must find that the designation order *would have been* necessary to the success of the plan, had the issue been raised at the start, and had the plan been successful. This is assuming that in all *ex post facto* cases the plan will have failed because otherwise the debts would have been fully paid.

One test for determining whether a designation order has been issued *ex post facto* is whether a court must support its order by findings about what *would have been* rather than by predictions about what *will be*. The basic difficulty with the *Deer Park* approach is that it encourages revisionist history and plunges the courts down a slippery slope of counterfactual reasoning. Ordinarily, of course, when a court engages in factfinding it attempts to determine what *actually* happened (when it happened, where it happened and to whom it happened). A court also sometimes engages in the much more difficult task of predicting future consequences (as when deciding child custody cases, or conducting bail hearings). Here, by contrast, a court is not asked to decide what was or what may be. It is instead invited to make up what *might have* been. This engages the creative abilities of judges more than it does their fact−finding abilities.

This Article has attempted to show how *Deer Park* illustrates the limits and the weaknesses of the *Energy Resources* rule which gives the bankruptcy courts the discretion to allow or disallow proposed designations of tax payments. As a matter of law, bankruptcy courts should have no power to grant designation orders *ex post facto*. Furthermore, the discretion to grant such orders should not be allowed in liquidation plans, but should be restricted to true rehabilitation plans where the designation order, in whatever form, is requested before the plan has failed, and such order should apply only to future plan payments. Even then, care should be taken in determining the true necessity of such an order for the success of the plan.

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**FOOTNOTES:**

[*] B.A. Haverford 1982, J.D. U.Va. 1987, M.A. U.Va. 1988, LL.M. Columbia 1993. Mr. Camp is currently an attorney in the Office of Chief Counsel of the Internal Revenue Service. This Article is intended to represent only his personal views and is not an official pronouncement of the Office of Chief Counsel. This Article has been reviewed and approved for publication by the Office of Chief Counsel pursuant to the Chief Counsel's Directive Manual (CCDM)(30)(11)13(4)(a). The author wishes to thank Larry Schattner for his comments and insights, so generously shared, and also Jack Williams for his help in bringing this Article to fruition. Back To Text

[1] 495 U.S. 545 (1990). Back To Text

[2] Id. at 551.Back To Text

[3] 10 F.3d 1478 (9th Cir. 1993).Back To Text

[4] *See, e.g.*, In re Flo−Lizer, Inc., 164 B.R. 79, 81 (Bankr. S.D. Ohio 1993).Back To Text

[5] Deer Park, 10 F.3d at 1481 (refusing to limit *Energy Resources* holding to nonliquidating Chapter 11 plans).Back To Text

[6] For further analysis, see Tal Marnin, Note, *Trust Fund Taxes in* Chapter 11 Liquidations: A Challenge to Energy Resources, 3 Am. Bankr. Inst. L. Rev. 231 (1995).Back To Text

[7] *See, e.g.,* I.R.C. § 3102(a) (1988 & Supp. V 1993) (social security taxes); id. § 3402(a)(1) (1988) (income taxes).Back To Text

[8] Id. § 7501(a) (1988); *see* United States v. Strebler, 313 F.2d 402, 404−05 (8th Cir. 1963). They are also called "third party" taxes because the duty is to collect someone else's tax. Slodov v. United States, 436 U.S. 238, 249 (1978).Back To Text

[9] Slodov, 436 U.S. at 242−43.Back To Text

[10] Initially, the idea of withholding was a byproduct of the creation of the social security system created by the Social Security Act of 1935, ch. 531, 49 Stat. 620. That Act set forth a scheme which imposed a (then 1.5%) tax (the social security tax) on both employees and employers and required employers not only to report and pay their own tax, but also to withhold the tax from employees' wages. Id. In 1943, Congress expanded the withholding scheme so as to require employers to withhold employees' income taxes as well as social security taxes. Current Tax Payment Act of 1943, ch. 120, 57 Stat. 126.Back To Text

[11] I.R.C. § 31(a) (1988); Slodov, 436 U.S. at 243.Back To Text

[12] Evans v. United States (In re Evans), 173 B.R. 725, 729 (D. Colo. 1994) (noting that nontrust fund taxes include corporate tax liabilities and FICA taxes, among others).Back To Text

[13] Ch. 21, 68A Stat. 415 (1954).Back To Text

[14] Ch. 23, 68A Stat. 439 (1954).Back To Text

[15] *See* Evans, 173 B.R. at 725.Back To Text

[16] I.R.C. § 6672 (1988 & Supp. V 1993). "Responsible person" is the shorthand term for those potentially liable officers and employees, although that phrase appears neither in statute nor regulation. The statute allows the penalty against any person "under a duty" without saying whether that duty has to arise from another statute or may arise from the internal procedures of the employer. Thus, a question arises as to whether the § 6672 penalty may be applied against the employee of a sole proprietorship. The IRS's revised Policy Statement P−5−60, *see 100−Percent Penalties, Transferee Assessments and Third Party Liabilities*, 1 Int. Rev. Man. (Admin.) (CCH) P−5−60, at 1305−14 (Feb. 2, 1993) [hereinafter *100−Percent Penalties*], uses the term "responsible person," as have the courts, but the Supreme Court has expressly declined to construe the term, even though using it at the same time. Slodov, 436 U.S. at 246 n.7.Back To Text

[17] Bledsoe v. United States, No. WN−92−1928, 1993 U.S. Dist. LEXIS 17275 (D. Md. Oct. 19, 1993).Back To Text

[18] *See 100−Percent* Penalties, supra note 16, at 1305−14.Back To Text

[19] I.R.C. § 3402 (1988 & Supp. V 1993) (requiring employers to withhold predetermined tax).Back To Text

[20] Monday v. United States, 421 F.2d 1210, 1218 (7th Cir.), cert. denied, 414 U.S. 821 (1970). Back To Text

[21] Slodov, 436 U.S. at 244−45.Back To Text

[22] Datlof v. United States, 370 F.2d 655, 656 (3d Cir. 1966), cert. denied, 387 U.S. 906 (1967).Back To Text

[23] In re Ribs−R−Us, Inc., 828 F.2d 199, 201 (3d Cir. 1987); Teel v. United States, 529 F.2d 903, 906 (9th Cir. 1976).Back To Text

[24] *See, e.g.,* Teel, 529 F.2d at 906 (holding corporation's stockholders responsible for TFRP); Ribs−R−Us, 828 F.2d at 201 (explaining that § 6672 liability of responsible persons survives filing of Chapter 11 plan).Back To Text

[25] *See* Ribs−R−Us, 828 F.2d at 200 (noting personal responsibility attaches to *any* responsible party who willfully withholds trust fund taxes). Back To Text

[26] *See* id. at 204 (explaining that monies applied to trust fund taxes diminish window of exposure to any responsible persons).Back To Text

[27] Id.Back To Text

[28] Id.Back To Text

[29] The federal tax collection scheme is, in general, a deliberate departure from the common law, and the government enjoys many powers and privileges which common law creditors lack. *See, e.g.*, S. Rep. No. 1708, 89th Cong., 2d Sess. 3 (1966), *reprinted in* 1966 U.S.C.C.A.N. 3722, 3747−50; *see* Michael I. Saltzman, IRS Practice and Procedure ¶ 14.05 (2d ed., 1991). Notwithstanding the highly statutory nature of tax law, courts may and do use common law rules when there are gaps in the statutory scheme, so long as the "power of judicial supplementation [is not] used to nullify valid regulations." Prussner v. United States, 896 F.2d 218, 225 (7th Cir. 1990) (en banc). *See, e.g.*, First Nat'l Bank v. United States, 591 F.2d 1143, 1148 (5th Cir. 1979) (construing Restatement (Second) of Contracts § 280B, Illus. 4 (1978) explaining that creditor must apply undesignated debtor payments to outstanding debts and not debts yet due); Datlof v. United States, 370 F.2d 655, 658 (3d Cir. 1966) ("In the absence of requests or directions [by payor], we know of no federal law of regulations which required the . . . [IRS] to apply . . . payments to the oldest item due or on a pro rata basis."), cert. denied, 387 U.S. 906 (1967). *Cf.* I.R.C. § 6402 (1988 & Supp. V 1993) (illustrating IRS's statutory right to apply "overpayments" to any liability owed to the IRS before refunding the surplus); United States v. Ryan (In re Ryan), 64 F.3d 1516, 1522 (11th Cir. 1995) (distinguishing partial payment situation, where common law rules apply, from overpayment situation where § 6402 governs); Kalb v. United States, 505 F.2d 506, 509 (2d Cir. 1974), cert. denied, 421 U.S. 979 (1975).Back To Text

[30] Rev. Rul. 79−284, 1979−2 C.B. 83, modifying Rev. Rul. 73−305, 1973−2 C.B. 43. It is not entirely clear whether a taxpayer has a true "right" to designate voluntary payments or whether the IRS merely honors such directions as a matter of policy. *Compare* United States v. Technical Knockout Graphics, Inc. (In re Technical Knockout Graphics, Inc.), 833 F.2d 797, 799 (9th Cir. 1987) (designation is a legal right) *with* In re Ribs−R−Us, Inc., 828 F.2d 199, 201 (3d Cir. 1987) (designation results from IRS policy).

For example, two early cases upheld the IRS's right to apply voluntary payments contrary to the taxpayers' explicit instructions. Lucas v. United States ex rel. Blackstone Mfg. Co., 45 F.2d 291, 292 (D.C. Cir. 1930); McCarl v. United States ex. rel. Leland, 42 F.2d 346, 347 (D.C. Cir.), cert. denied, 282 U.S. 839 (1930). In *Lucas*, the taxpayer was assessed a deficiency of $11,000 for the year 1918. Lucas, 45 F.2d at 291. He contested the deficiency and eventually lost before the Board of Tax Appeals in October 1927. Id. During the week of that decision, the taxpayer paid the IRS, specifically directing that the money be applied to the 1918 deficiency. Id. In November, 1927, the IRS, as the result of another disagreement with the taxpayer, scheduled an overpayment of approximately $10,000 for the year 1917 and approximately $3,000 for the year 1919. Id. The IRS then credited the 1917 and 1919 overpayments to the 1918 deficiency, completely ignoring the taxpayer's direction of how to apply its 1927 voluntary payment. Id. The D.C. Circuit upheld this application. Id. The fact pattern in *McCarl* was similar in all material respects. The courts in these cases appear chiefly to have been concerned with the fact that the Revenue Act of 1926, ch. 27, 44 Stat. 9, 66, did not permit the government to charge interest on pre−1926 deficiencies until February 26, 1926, but interest on pre−1926 overpayments was allowed from the date of overpayment. Lucas, 45 F.2d at 292; McCarl, 42 F.2d at 347.

I suggest that it is better to view the taxpayer as having a right to designate the application of payments, absent some explicit language to the contrary in the IRC. First, a common law right is as legitimate as any statutory right and should not be ignored. In Kalb v. United States, 505 F.2d 506 (2d Cir. 1974), the court opined that "although in other areas of the law a payor may have power to direct application of voluntary payments, we find no basis for such power in tax law." Id. at 509. The error here was that the court looked no further than the tax law. Simply because there is no IRC basis for a right does not mean there cannot be an alternate basis for that right. Second, the *Lucas* and *McCarl* cases are consistent with this common law view because in each case the courts, in admirable common law fashion, responded to certain circumstances under which strict application of this rule would be unfair. *See* Lucas, 45 F.2d at

292; McCarl, 42 F.2d at 347.Back To Text

[31] Muntwyler v. United States, 703 F.2d 1030, 1031 (7th Cir. 1983) (explaining that taxpayer does not have authority to designate how involuntary payments are to be applied).Back To Text

[32] United States v. Technical Knockout Graphics, Inc. (In re Technical Knockout Graphics, Inc.), 833 F.2d 797, 799 (9th Cir. 1987).Back To Text

[33] Ribs−R−Us, 828 F.2d at 201.Back To Text

[34] *100−Percent* Penalties, supra note 16, at 1309−10.Back To Text

[35] Fullmer v. United States (In re Fullmer), 962 F.2d 1463, 1468 (10th Cir. 1992); DuCharmes & Co. v. Michigan (In re DuCharmes & Co.), 852 F.2d 194, 194 (6th Cir. 1988); Technical Knockout, 833 F.2d at 802−03; Ribs−R−Us, 828 F.2d at 199; *cf.* United States v. A & B Heating & Air Conditioning, Inc. (In re A & B Heating & Air Conditioning), 823 F.2d 462, 465−66 (11th Cir. 1987) (holding that bankruptcy court has discretion to determine allocation issues on case−by−case basis).Back To Text

[36] The classic definition of an involuntary payment was articulated in Amos v. Commissioner, 47 T.C. 65 (1966), as "any payment received by agents of the United States as a result of distraint or levy or from a legal proceeding in which the Government is seeking to collect its delinquent taxes or file a claim therefor." Id. at 69.Back To Text

[37] IRS v. Energy Resources Co. (In re Energy Resources Co.), 871 F.2d 223, 230−31 (1st Cir. 1989); United States v. Energy Resources Co., 495 U.S. 545, 546 (1990).Back To Text

[38] Energy Resources, 495 U.S. at 547.Back To Text

[39] Id.Back To Text

[40] Id.Back To Text

[41] Id.Back To Text

[42] Id. at 547−48.Back To Text

[43] IRS v. Energy Resources Co. (In re Energy Resources Co.), 871 F.2d 223, 226−27 (1st Cir. 1989), aff'd, 495 U.S. 545 (1990).Back To Text

[44] Id. at 226.Back To Text

[45] Id. at 234.Back To Text

[46] Energy Resources, 495 U.S. at 546.Back To Text

[47] Id. at 551. In DuCharmes & Co. v. Michigan (In re DuCharmes & Co.), 852 F.2d 194 (6th Cir. 1988), the Sixth Circuit overturned the district court's approval of a provision in the debtor's Plan of Reorganization which designated payments to the IRS. Id. at 196. In light of *Energy Resources*, the Sixth Circuit's decision in this regard clearly was wrong.Back To Text

[48] Energy Resources, 495 U.S. at 549.Back To Text

[49] 11 U.S.C. § 105(a) (1994).Back To Text

[50] Id. § 1123(b)(6).Back To Text

[51] Energy Resources, 495 U.S. at 549−50.Back To Text

[52] Id.Back To Text

[53] 11 U.S.C. § 1129(a)(9)(C) (1994).Back To Text

[54] Energy Resources, 495 U.S. at 550−51.Back To Text

[55] Id. at 551.Back To Text

[56] 11 U.S.C. § 1129(a)(11) (1994); Energy Resources, 495 U.S. at 549; *see* Heartland Fed. Sav. & Loan Ass'n v. Briscoe Enters., Ltd., II (In re Briscoe Enters., Ltd., II), 994 F.2d 1160, 1165 (5th Cir.) (stating that "the court need not require a guarantee of success") (citing In re Lakeside Global II, Ltd., 116 B.R. 499, 507 (Bankr. S.D. Tex. 1989)), cert. denied, 114 S. Ct. 550 (1993).Back To Text

[57] Energy Resources, 495 U.S. at 550.Back To Text

[58] Id. at 550−51.Back To Text

[59] Id. at 550 (emphasis added).Back To Text

[60] Id. at 551.Back To Text

[61] IRS v. Energy Resources Co. (In re Energy Resources Co.), 871 F.2d 223, 233−34 (1st Cir. 1989), aff'd, 495 U.S. 545 (1990).Back To Text

[62] *See, e.g.*, United States v. Pepperman, 976 F.2d 123, 130−31 (3d Cir. 1992); In re Suburban Motor Freight, Inc., 161 B.R. 640, 643−44 (S.D. Ohio 1993).Back To Text

[63] Energy Resources, 871 F.2d at 234.Back To Text

[64] Id. at 230−31.Back To Text

[65] Id. at 231 (recognizing "the compromise nature of Chapter 11's tax debt policy").Back To Text

[66] For example, the Bankruptcy Code grants many tax debts priority status under § 507(a)(8) and makes many tax debts nondischargeable under § 523. *See* 11 U.S.C. § 507(a)(8) (1994) (granting priority status to many tax debts); Id. § 523 (1994) (providing for nondischargeability of many tax debts).Back To Text

[67] H.R. Rep. No. 595, 95th Cong., 1st Sess. 220 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6179. "The purpose of a business reorganization case . . . is to restructure 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." Id.Back To Text

[68] S. Rep. No. 989, 95th Cong., 2d Sess. 13−14 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5799−800.Back To Text

[69] *See* infra notes 178−190 and accompanying text (exploring dubiousness of this proposition).Back To Text

[70] *See* United States v. Energy Resources Co., 495 U.S. 545, 551 (1990).Back To Text

[71] Id. at 549 (holding that bankruptcy court may order designation where designation "is necessary to the success of a reorganization plan").Back To Text

[72] 11 U.S.C. § 105(a) (1994) (emphasis added) ("The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title.").Back To Text

[73] *See, e.g.,* GLK, Inc. v. United States (In re GLK, Inc.), 921 F.2d 967, 968 (9th Cir. 1990) (holding Energy Resources only applies when bankruptcy court finds such allocation is necessary to success of bankruptcy plan), cert. denied, 501 U.S. 1205 (1991); In re Visiting Nurse Ass'n, 128 B.R. 835, 837 (Bankr. M.D. Fla. 1991).Back To Text

[74] *See, e.g.,* United States v. Pepperman, 976 F.2d 123, 129 (3d Cir. 1992) (Chapter 7 liquidation); United States v. Kare Kemical, Inc. (In re Kare Kemical, Inc.), 935 F.2d 243, 244 (11th Cir. 1991) (Chapter 11 liquidation); Jehan−Das, Inc. v. United States (In re Jehan−Das, Inc.), 925 F.2d 237, 238 (8th Cir.) (same), cert. denied, 502 U.S. 810 (1991); *In re* T.M. Prods. Co., No. 90−6734 Civ., 1992 U.S. Dist. LEXIS 9404, at *7 (S.D. Fla. June 4, 1992) (confirmed Chapter 11 reorganization plan failed resulting in liquidation; held that "payments made after reorganization attempts ceased should not be subject to the . . . designation"); In re Peter DelGrande Corp., 138 B.R. 458, 464 (Bankr. D.N.J. 1992) (Chapter 7 liquidation); Visiting Nurse Ass'n, 128 B.R. at 837 (Chapter 11 liquidation); In re Arie Enters., Inc., 116 B.R. 641, 642 (Bankr. S.D. Ill. 1990) (same). *But see* IRS v. Creditors Comm. (In re Deer Park, Inc.), 10 F.3d 1478, 1483−84 (9th Cir. 1993) (approving designation order in liquidating Chapter 11); *In re* 20th Century Enters., 94−2 U.S. Tax. Cas. (CCH) ¶ 50,561 (Bankr. N.D. Miss. 1995), *aff'd*, No. 1:94CV219−D−D, slip op. (N.D. Miss. July 20, 1995); In re Flo−Lizer, Inc., 164 B.R. 79, 82 (Bankr. S.D. Ohio 1993) (same), aff'd, 164 B.R. 749 (S.D. Ohio 1994).Back To Text

[75] 976 F.2d 123 (3d Cir. 1992).Back To Text

[76] Id. at 131.Back To Text

[77] Id. at 124−25.Back To Text

[78] Id. at 125Back To Text

[79] Id.Back To Text

[80] Pepperman, 976 F.2d at 125; *see* supra notes 7−34 and accompanying text (discussing IRS's ability to designate tax payments).Back To Text

[81] United States v. Pepperman (*In re* Sorensen), No. 91−3711, 1991 U.S. Dist. LEXIS 14598, at *7 (D.N.J. Oct. 10, 1991), *rev'd*, 976 F.2d 123, 130 (3d Cir. 1992).Back To Text

[82] *Id.* at *7−9.Back To Text

[83] *Id.* at *6−7.Back To Text

[84] Pepperman, 976 F.2d at 132.Back To Text

[85] Id. at 130 (recognizing that balance "must be struck in favor of rehabilitation").Back To Text

[86] Id. Back To Text

[87] Id.Back To Text

[88] Id.Back To Text

[89] Pepperman, 976 F.2d at 130−31; *see* 11 U.S.C. § 507(a)(8)(C) (1994). In In re Suburban Motor Freight, Inc., 161 B.R. 640 (S.D. Ohio 1993), also a Chapter 7 liquidation case, the court agreed with *Pepperman* that a designation order "would effectively weaken the general rule that the government is entitled to priority over general creditors for the payment of 6672 liability. The designation of payment would secure for Mr. McIntyre [the responsible officer]

rights and privileges which he does not otherwise possess." Id. at 644.Back To Text

[90] Pepperman, 976 F.2d at 130−31.Back To Text

[91] Id.Back To Text

[92] Id. at 129.Back To Text

[93] Id. at 130 (quotes and brackets omitted).Back To Text

[94] Id.Back To Text

[95] *See* supra notes 73−74 (listing cases construing *Energy Resources*).Back To Text

[96] *See* supra note 74.Back To Text

[97] 10 F.3d 1478, 1482 (9th Cir. 1993).Back To Text

[98] Id. at 1480.Back To Text

[99] Id.Back To Text

[100] Id.Back To Text

[101] Id. at 1480−81.Back To Text

[102] Deer Park, 10 F.3d at 1480.Back To Text

[103] Id. at 1481.Back To Text

[104] Id.Back To Text

[105] Id.Back To Text

[106] Id.Back To Text

[107] Deer Park, 10 F.3d at 1480.Back To Text

[108] Id.Back To Text

[109] Id.Back To Text

[110] Id. at 1484 (Ferguson, J., dissenting).Back To Text

[111] Id. at 1481.Back To Text

[112] Deer Park, 10 F.3d at 1481.Back To Text

[113] Id.Back To Text

[114] Id.Back To Text

[115] Id.Back To Text

[116] Id.Back To Text

[117] Deer Park, 10 F.3d at 1481.Back To Text

[118] United States v. Deer Park, Inc. (In re Deer Park, Inc.), 136 B.R. 815, 817 (Bankr. 9th Cir. 1992), aff'd, 10 F.3d 1478 (9th Cir. 1993).Back To Text

[119] Deer Park, 10 F.3d at 1480.Back To Text

[120] Id. at 1481−82; Deer Park, 136 B.R. at 815.Back To Text

[121] Deer Park, 10 F.3d at 1481−82; Deer Park, 136 B.R. at 817.Back To Text

[122] Deer Park, 136 B.R. at 818.Back To Text

[123] Id.Back To Text

[124] Id.Back To Text

[125] Id. Back To Text

[126] Id.Back To Text

[127] *See* IRS v. Creditors Comm. (In re Deer Park, Inc.), 10 F.3d 1478, 1482 (9th Cir. 1993) ("It does not matter that the Chapter 11 reorganization plan is a liquidating plan, so long as the allocation of trust fund tax payments is necessary to the success of the reorganization.").Back To Text

[128] 11 U.S.C. § 1129(a)(9)(C) (1994).Back To Text

[129] Id. § 1129(a)(7).Back To Text

[130] Deer Park, 10 F.3d at 1481.Back To Text

[131] As Judge Baynes noted in In re Visiting Nurse Ass'n, 128 B.R. 835, 837 (Bankr. M.D. Fla. 1991), another Chapter 11 liquidation case: "There is no conceivable way Debtor will benefit from such a designation." Id. *Accord In re* T.M. Prods. Co., No. 90−6734, 1992 U.S. Dist. LEXIS 9404, at *2 (S.D. Fla. June 4, 1992) ("In an involuntary liquidation, after which the debtor will not exist, there is no policy reason for allowing the debtor to designate payments.").Back To Text

[132] *See* Elizabeth Warren, Bankruptcy Policy, 54 U. Chi. L. Rev. 775, 787−88 (1987).

> But the revival of an otherwise failing business also serves the distributional interests of many who are not technically 'creditors' but who have an interest in a business's continued existence. Older employees who could not have retrained for other jobs, customers who would have to resort to less attractive, alternative suppliers of goods and services, suppliers who would have lost current customers, nearby property owners who would have suffered declining property values, and states or municipalities that would have faced shrinking tax bases benefit from the reorganization's success.

Id.Back To Text

[133] H.R. Rep. No. 595, supra note 67, at 220, *reprinted in* 1978 U.S.C.C.A.N. at 6179.Back To Text

[134] 3 Chapter 11 Theory and Practice: A Guide to Reorganization § 16.04, at 16:7 (Philip J. Hendel et al. 1994) ("In current law, there is a policy choice that fosters reorganization of a company as a going concern, operating through

various methodologies in the Code to achieve this result.").Back To Text

[135] IRS v. Creditors Comm. (In re Deer Park, Inc.), 10 F.3d 1478, 1480 (9th Cir. 1993).Back To Text

[136] Id. at 1484 (Ferguson, J., dissenting).Back To Text

[137] Id. at 1480.Back To Text

[138] 148 B.R. 259 (Bankr. S.D. Tex. 1992).Back To Text

[139] Id. at 261.Back To Text

[140] Id. at 262.Back To Text

[141] Id.Back To Text

[142] Id.Back To Text

[143] *See* supra note 26 and accompanying text.Back To Text

[144] 11 U.S.C. § 523(e) (1994).Back To Text

[145] *See, e.g.*, Humble Place Joint Venture v. Fory (In Re Humble Place Joint Venture), 936 F.2d 814, 818 (5th Cir. 1991). Where a partnership filed for bankruptcy primarily to obtain relief from individual partners' guarantees to undersecured creditors, the court held that the petition should be dismissed for having been filed in bad faith because "[p]ersonal guarantees of non−debtors are not ordinarily . . . a legitimate concern of Chapter 11." Id.Back To Text

[146] For example, the general common law rule permits creditors to apply payments to whichever debts of the debtor best serves their interest so long as the payment is either involuntary or the debtor does not designate them. *See* supra notes 29−32 and accompanying text. However, "as between debts already due and debts not yet owing, . . . [a creditor] must apply a payment to the due debts." First Nat'l Bank v. United States, 591 F.2d 1143, 1148 (5th Cir. 1979) [hereinafter *Palm Beach*] (requiring IRS to apply taxpayer's voluntary but undesignated payments to assessed trust fund taxes before it could apply them to accrued but unassessed penalties and interest on nontrust fund taxes). This is a rule created for the protection of debtors. Id. Yet, in cases concerning trust fund taxes, even the best judges can confuse the responsible person with the debtor and apply the rule for the responsible person's benefit when it has no application to the debtor. For example, in Stevens v. United States, 49 F.3d 331 (7th Cir. 1995), the responsible person was Stevens. He owned a company called New Horizons which under his guidance had accumulated large trust fund tax deficiencies. Id. at 333. The IRS levied on New Horizons' sole asset, a building, and applied the proceeds from the sale of the asset to nontrust fund payments. Id. New Horizons dissolved and the IRS then went after Stevens for the balance of the trust fund taxes. Id. Stevens paid a portion and sued for a refund, claiming, *inter alia*, that the IRS had improperly applied the levy proceeds to New Horizons' accrued but unassessed interest and penalties on its nontrust fund taxes before applying the proceeds to New Horizons' trust fund taxes, thus violating the *Palm Beach* rule. Stevens v. United States, No.93 c 1000, 1993 U.S. Dist. LEXIS 15396, at *15−16 (N.D. Ill. Nov. 2, 1993) (discussing *Palm Beach* rule as stated in First Nat'l Bank v. United States, 591 F.2d 1143 (5th Cir. 1979)). If the IRS had made the correct application, he would not owe any tax. The district court agreed with Stevens that *Palm Beach* applied. *Id.* at *14. Judge Posner, for the Seventh Circuit, reversed, holding that *Palm Beach* applied only to voluntary and not involuntary payment cases such as Stevens. Stevens, 49 F.3d at 334.

What both the district court and circuit court missed completely was that Stevens was not the right party to invoke the *Palm Beach* rule. He wanted to reorder the payments made by someone else (here, New Horizons, which was defunct). But the *Palm Beach* rule could not possibly help New Horizons; it was no longer in existence. Even if the rule were in existence, it might actually hurt New Horizons because it negated the possibility that its overall tax exposure could be reduced by discharging potential alternate sources for tax collection. Thus, if someone other than Stevens had been in control of New Horizons, it is difficult to imagine why the company would want to invoke the

*Palm Beach* rule. Back To Text

[147] 164 B.R. 79 (Bankr. S.D. Ohio 1993), aff'd, 164 B.R. 749 (S.D. Ohio 1994).Back To Text

[148] Id. at 82 (stating that principals' actions resulted in successful reorganization albeit through liquidating Chapter 11 plan).Back To Text

[149] Debtor's Third Amended Plan of Reorganization at 21, *Flo−Lizer* (No. 2−86−01685) [hereinafter Third Amended Plan].Back To Text

[150] *See* Flo−Lizer, 164 B.R. at 80 (noting that both parties agreed that *Energy Resources* "is either controlling, or critical to determination of Debtor's Motion").Back To Text

[151] Id. at 82 (stating that "[m]ost liquidating Chapter 11 proceedings would not fit within the parameters required to allow for such a ruling").Back To Text

[152] Third Amended Plan, supra note 149, at 21.Back To Text

[153] *See* IRS v. Energy Resources Co. (In re Energy Resources Co.), 871 F.2d 223, 226−27 (1st Cir. 1989), aff'd, 495 U.S. 545 (1990).Back To Text

[154] Third Amended Plan, supra note 149, at 28.Back To Text

[155] In re Flo−Lizer, 164 B.R. 79, 82 (Bankr. S.D. Ohio 1993), aff'd, 164 B.R. 749 (S.D. Ohio 1994).Back To Text

[156] Third Amended Plan, supra note 149, at 5.Back To Text

[157] Flo−Lizer, 164 B.R. at 82.Back To Text

[158] Id.Back To Text

[159] Id.Back To Text

[160] 11 U.S.C. § 364(d)(1) (1994) (allowing court to grant senior lien on property previously encumbered if it provides adequate protection to prior lienholder).Back To Text

[161] Flo−Lizer, 164 B.R. at 80 (noting that responsible persons would not have contributed had they believed that they would be personally responsible for taxes).Back To Text

[162] 11 U.S.C. § 364 (1994) (establishing limitations on court's power to authorize obtaining of credit).Back To Text

[163] *See* IRS v. Energy Resources Co. (In re Energy Resources Co.), 871 F.2d 223, 230 (1st Cir. 1989) (citing Deborah A. Dyson, Note, Bankruptcy Court Jurisdiction and the Power to Enjoin the IRS, 70 Minn. L. Rev. 1279, 1299−1300 (1986)), aff'd, 495 U.S. 545 (1990).Back To Text

[164] United States v. Deer Park, Inc. (In re Deer Park, Inc.), 136 B.R. 815, 819 (Bankr. 9th Cir. 1992), aff'd, 10 F.3d 1478 (9th Cir. 1993).Back To Text

[165] Id.Back To Text

[166] Id.Back To Text

[167] IRS v. Creditors Comm. (In re Deer Park, Inc.), 10 F.3d 1478, 1482 (9th Cir. 1993).Back To Text

[168] United States v. Energy Resources Co., 495 U.S. 545, 551 (1990).Back To Text

[169] 11 U.S.C. § 1129(a)(9)(C) (1994).Back To Text

[170] Energy Resources, 495 U.S. at 549.Back To Text

[171] *See* Deer Park, 10 F.3d at 1481−82 (noting that debtors participation in liquidations can be just as important as in reorganizations).Back To Text

[172] Id. at 1480.Back To Text

[173] Id. at 1481.Back To Text

[174] Id.Back To Text

[175] Id.Back To Text

[176] Id. at 1480.Back To Text

[177] It probably is true that the designation order did not violate the Bankruptcy Code any more in *Deer Park* than in *Energy Resources*. In both cases, the order did not affect what the IRS received under the plan. Thus, the Ninth Circuit thought it was of some importance that no other creditor received money which should have gone to the IRS. Deer Park, 10 F.3d at 1482−83. The court said that since no other "holder of a claim" of the same or superior class of creditors received any money that the IRS should have, the absolute priority rule embodied in § 1129(a)(7) was not violated. Id. The court's point apparently is if the *possibility* that the IRS would not be fully paid was irrelevant to the *Energy Resources* analysis, the same possibility should be equally irrelevant here. The *Deer Park* designation order no more changed what the IRS actually received than the designation order did in *Energy Resources*, so it is no more violative of the Bankruptcy Code than was the order there. Likewise, the order here actually *requires* the IRS to fulfill the objective of § 6672. The point is true enough, but of trivial importance. The *fact* that the IRS would not be fully paid weighs so heavily in the IRS's favor in the balancing analysis (since it means that the risk of plan failure has become a certainty), that it justifies a *per se* rule in *ex post facto* cases. Back To Text

[178] United States v. Deer Park, Inc. (In re Deer Park, Inc.), 136 B.R. 815, 819 (Bankr. 9th Cir. 1992), aff'd, 10 F.3d 1478 (9th Cir. 1993).Back To Text

[179] Id.Back To Text

[180] IRS v. Creditors Comm. (In re Deer Park, Inc.), 10 F.3d 1478, 1484 (9th Cir. 1993) (Ferguson, J., dissenting). If Stoll truly had such an understanding with the Creditors Committee, he might have a cause of action against them because it was their mistake in drafting the December payment order that caused the underpayment; in effect, they "breached" this "understanding." But if Stoll's "understanding" is not even enforceable against the Creditors Committee, it should not be enforceable against a particular creditor.Back To Text

[181] *See* infra note 189 and accompanying text. Back To Text

[182] *See* Cecelia N. Anekwe, Comment, Responsible Officers Get Green Light at the Intersection of the Tax and Bankruptcy Codes, 21 Seton Hall L. Rev. 868, 879 n.72 (1991).Back To Text

[183] Given the other factors that will be considered in the responsible person's willingness or desire to participate in the reorganization, it might reasonably be questioned whether this analysis applies only on the margin. To the extent that this *is* a marginal analysis, then the whole balancing rationale for allowing designation orders in rehabilitation cases loses considerable force. What now shall go on the scales against the goal of revenue protection? If a designation order is only a weak, marginal, incentive for the responsible person to engage in the reorganization effort (which I would suggest is truly the case *ex ante*), then it is difficult to imagine how it can at the same time be "necessary" to

ensure the responsible person's participation. What is considered "marginal" usually is not also considered "necessary." On the other side of the scales, however, whenever a designation order is sought, revenue protection will rarely, if ever, be a marginal consideration since the very act of asking for the order indicates that there is doubt about the likelihood of full payment.Back To Text

[184] Deer Park, 10 F.3d at 1480.Back To Text

[185] Id. at 1485 (Ferguson, J., dissenting) (stating that Chapter 11 not designed to benefit third parties like Stoll).Back To Text

[186] Deer Park, 10 F.3d at 1480. If Alpine Meadows was to use the ski area for downhill skiing within ten years, it would have to transfer to Deer Park a 25% equity interest in the operation as well as pay Deer Park 60% of the net operating cash flow up to $1.5 million. Id.Back To Text

[187] Id. If Alpine Meadows was to resell the property within five years, Deer Park would receive 50% of the sale price that exceeded the original purchase price of $275,000. Id.Back To Text

[188] Id. (noting that Creditors Committee's Disclosure Statement "cautioned that there was no assurance or present indication that either event would occur"); *see* id. at 1485 (Ferguson, J., dissenting) (noting that removal of ski lifts precluded operation of downhill skiing area).Back To Text

[189] IRS v. Creditors Comm. (In re Deer Park, Inc.), 10 F.3d 1478, 1482 (stating possibility that ski area would re−open was fundamental part of plan).Back To Text