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The Statutory Trust Fund Under IRC § 7501 (a) Versus Administrative Expenses in Bankruptcy - In re Halo Metal Products, Inc.

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In re *Halo Metal Products, Inc.*[1]

On August 18, 1967, Halo Metal Products filed a petition for an arrangement under Chapter XI of the Bankruptcy Act.[2] Pursuant to section 342 of Chapter XI,[3] Halo was continued as a debtor-in-possession. During its operation as such, Halo paid wages to its

1. 419 F.2d 1068 (7th Cir. 1969).
2. 11 U.S.C. §§ 701-99 (1964). Chapter XI allows a debtor, without suffering complete liquidation, to extend and settle unsecured debts by agreement with a majority of his creditors and with court approval.
3. 11 U.S.C. § 742 (1964). A receiver or trustee may be appointed to manage the debtor's property during the arrangement [11 U.S.C. § 732 (1964)] or the debtor may continue to manage his property under court control.

employees and became liable to the federal government for sums withheld from those wages for income and F.I.C.A. taxes.[4] On November 22, 1967, Halo was adjudged a bankrupt; liquidation followed. The sum realized from the sale of Halo's assets exceeded the government's claim for withheld monies by only a few hundred dollars. If that claim were first paid, as the government contended it must be under the trust fund language of section 7501(a) of the Internal Revenue Code of 1954, then claims for administrative expenses would not be fully paid. The Court of Appeals for the Seventh Circuit, affirming decisions of the referee and the district court,[5] refused to find a trust in favor of the United States for the withholdings.

In earlier decisions three other circuit courts of appeal[6] had not only recognized the trust, but had also held that the government was not required to trace specific funds because of the official status of the debtor-in-possession paying the wages.[7] Although the Supreme Court could have phrased its holding in a 1966 case[8] so as to agree with the *Halo* position, it expressly declined to do so. On the other hand, in 1964 the Third Circuit did rule, without significant discussion and on somewhat different facts, that the trust fund language of section 7501(a) is subordinate to the priority language of section 64 of the Bankruptcy Act.[9] The reasoning of the *Halo* opinion and of the Third Circuit is that the United States is at *no* time entitled to recover on a section 7501(a) trust theory in bankruptcy. Under this reasoning the United States could not recover withheld taxes even if it could trace them to a separate bank account. Nor, it seems, could the government assert a trust claim where the bankrupt was, in fact, *enriched* by taxes actually paid to him by a third-party tax debtor.[10]

Ordinarily, property held by the bankrupt as trustee does not pass to his creditors, but is set aside for the beneficiary by the trustee in bankruptcy.[11] In *Halo* the court concluded that section 7501(a) did not enable the government to gain this super-priority. It gave three reasons: first, the court read the first sentence of section 7501(a) as subjected by its second sentence to the priorities in section 64(a) of the Bankruptcy Act;[12] second, the court pointed to Supreme Court decisions which had held that section 64(a) bankruptcy priorities override priorities granted to the federal government by non-bank-

4. Withholding was pursuant to 26 U.S.C. §§ 3101, 3102 (1964) (Federal Insurance Contributions Act) and 26 U.S.C. § 3402 (1964) (income tax).

5. 302 F. Supp. 614 (N.D. Ill. 1968).

6. The Second, Sixth and Ninth Circuits: *In re* Airline-Arista Printing Corp., 156 F. Supp. 403 (S.D.N.Y. 1957), *aff'd per curiam*, 267 F.2d 333 (2d Cir. 1959); Hercules Serv. Parts Corp. v. United States, 202 F.2d 938 (6th Cir. 1953); United States v. Sampsell, 193 F.2d 154 (9th Cir. 1951).

7. *See* notes 49–56 *infra* and accompanying text.

8. Nicholas v. United States, 384 U.S. 678 (1966).

9. *In re* Connecticut Motor Lines, Inc., 336 F.2d 96 (3d Cir. 1964).

10. For example, those excise taxes discussed at notes 28, 30, 31 *infra* and accompanying text.

11. 4A W. COLLIER, BANKRUPTCY ¶ 70.25[1] (14th ed. 1969). *See, e.g.*, Todd v. Pettit, 108 F.2d 139 (5th Cir. 1939); *In re* Coffin, 152 F. 381 (2d Cir. 1907); *In re* Tate-Jones & Co., 85 F. Supp. 971 (W.D. Pa. 1949).

12. 11 U.S.C. § 104(a) (1964).

ruptcy legislation such as section 3466 of the Revised Statutes;[13] and finally, the court concluded that section 64(a) embodies a strong and overriding policy against such a government priority, pointing to parallel trends in the development of section 64 which reflect a growing recognition of the inequity of extending to the government extraordinary preferences over other creditors and an increasing realization that sound bankruptcy administration depends upon insuring payment of expenses necessarily incurred in such administration.

I. INTERPRETATION OF SECTION 7501(a)

Section 7501(a) reads as follows:

> *General Rule.* — Whenever any person is required to collect or withhold any internal revenue tax from any other person and to pay over such tax to the United States, the amount of tax so collected or withheld shall be held to be a special fund in trust for the United States. The amount of such fund shall be assessed, collected, and paid in the same manner and subject to the same provisions and limitations (including penalties) as are applicable with respect to the taxes from which such fund arose.

The Seventh Circuit takes the position that the second sentence of this section makes the trust fund imposed by the first sentence subject to the same status in Halo's bankruptcy as an unsecured claim for taxes incurred by Halo itself. Such a claim arising during a Chapter XI arrangement shares only a pro rata priority with all other administrative expenses of the arrangement[14] and is subordinate to administrative expenses of the liquidating bankruptcy under section 64(a)(1).[15] The court sees the section 64(a) scheme as an applicable "provision or limitation" within the meaning of the second sentence.

There are several problems presented by this reading. When one looks at the theoretical operation of the Federal Insurance Contributions Act,[16] he sees the employee earning a periodic wage from which the employer will withhold a certain percentage, which sum the employer will turn over to the government to satisfy the employee's tax obligation. Why should the sums withheld from the employee ever

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13. The statute dates back to 1797. Ch. 20, § 5, 1 Stat. 515. It is now 31 U.S.C. § 191 (1964). Section 3466 declares a government priority in insolvency:

> Whenever any person indebted to the United States is insolvent, or whenever the estate of any deceased debtor, in the hands of the executor or administrators, is insufficient to pay all the debts due from the deceased, the debts due the United States shall be first satisfied . . . .

The statute would be invoked only when the government competes as an unsecured creditor. Any lien or other secured claim would be governed by the usual priorities among secured claimants.

14. *See, e.g.*, Missouri v. Earhart, 111 F.2d 992, 995 (8th Cir. 1940).

15. As of 1952, the administrative expenses of a liquidating bankruptcy which supersedes another debtor-relief proceeding under the Bankruptcy Act are granted a sub-priority within section 64(a)(1) and are paid before the administrative expenses of the superseded proceeding.

16. 26 U.S.C. §§ 3101-26 (1964).

become a part of his employer's estate or be used to pay administrative expenses or to satisfy claims of the employer's creditors?[17] The *Halo* court did not discuss this difficulty. It is true that withholdings have been viewed as taxes due from the employer. In *United States v. New York*,[18] it was held that the government's claim to social security withholdings upon the employer's bankruptcy would fall within section 64(a)(4).[19] The obligations of the employer were regarded as having all the characteristics of a tax on the employer himself, being imposed upon the employer regardless of whether he had in fact made deductions from his employees' wages.[20] The question of the status of the withholdings arose when New York argued that the federal claim ought to fall within section 64(a)(5) as a mere debt claim, rather than within section 64(a)(4) as a claim for taxes due and owing *by the bankrupt*. The conclusion that a claim for the particular monies withheld in the *New York* case was a claim for taxes due and owing by the bankrupt employer ought not to be silently absorbed in *Halo*. The government did not there contend for any status higher than that of section 64(a)(4), and nowhere in the opinion in *United States v. New York* does the Supreme Court mention section 7501(a) and the special status that section gives to the withheld sums.

Moreover, it is not at all clear, despite the authorities cited by the court, that "provisions and limitations" as used in the second sentence of section 7501(a) would encompass bankruptcy priorities. The sentence reads, "The amount of such fund shall be assessed, collected, and paid in the same manner and subject to the same provisions and limitations (including penalties) as are applicable with respect to the taxes from which such fund arose." It is clear that "subject to the same provisions and limitations" modifies "shall be assessed, collected, and paid." In the sense that the court reads "assessed, collected, and paid," it embraces the process of assigning a priority in insolvency. However, an alternative reading would limit the phrase to embrace only a technical procedure, *i.e.*, the tax collection steps set out in the Internal Revenue Code.[21] There are certain weapons available to the government to compel payment.[22] There are limitations on what the government may assess, collect, and be paid: the government may not be allowed to assess or collect certain penalties;[23] it may not be able

17. The sums would presumably not be carried as assets on the company books, so that no creditor who examined a balance sheet would be deceived by the recognition of a trust fund.

18. 315 U.S. 510 (1942).

19. Section 64(a)(4) is the priority ordinarily granted to an unsecured claim for taxes. *United States v. New York* involved no Chapter XI proceeding.

20. 315 U.S. at 515–16.

21. *See generally* INT. REV. CODE of 1954, §§ 6001–6344. This reading seems to be confirmed by the use of identical language in other sections of the Revenue Act of 1934. *E.g.*, ch. 277, § 311(a), 48 Stat. 748.

22. For example, liens and seizure. INT. REV. CODE of 1954, §§ 6321–44.

23. Sections 6651–83 of the Internal Revenue Code of 1954 impose additional taxes and penalties. One limitation would be that a penalty or an addition to tax cannot be imposed if the taxpayer was not willfully negligent. *E.g.*, *id.* at §§ 6651(a), 6672. The Bankruptcy Act itself disallows collection of certain tax penalties. 11 U.S.C. § 93(j) (1964) (§ 57(j) of the Act).

to collect interest in certain circumstances;[24] its claim may be barred by the statute of limitations.[25]

If the *Halo* court's reading be adopted, what does the creation of a trust fund avail the government? According to the *Halo* reasoning, the government has no rights greater than those it would have as collector of an ordinary tax debt due from the employer. If Congress had intended this result, would it not more likely have characterized the withholdings as "taxes due from the person withholding or collecting" than as a trust fund?

Section 7501(a) was originally enacted as section 607 of the Revenue Act of 1934.[26] At that time there were no social security or income tax withholdings by employers.[27] When enacted, the section covered such taxes as those to be withheld on bank checks and drafts[28] and on income of nonresident aliens,[29] and those to be collected on telephone, telegraph, radio, and cable messages,[30] and on admissions.[31] The Senate Committee Report on the proposed bill[32] and the House Conference Report on amendments to its proposed version[33] are quoted by the Seventh Circuit as confirming that the major goal of enactment of section 607 was to make available to the government certain favorable collection procedures; *i.e.,* it was not a stressed goal to give the government priority in cases of insolvency. Yet the reports are equivocal. The Senate Report states that a change is sought so that the withholder will no longer be a mere debtor, but can be treated as a trustee and proceeded against by distraint. The House Report says that the amendment will impress withheld taxes with a trust and will make available certain administrative provisions applying to the assessment, collection, and payment of taxes.

In truth, this legislative history sheds little light on the *Halo* problem. The court reaches the conclusion that, because the legislative reports do not specifically mention an intent to give the withheld taxes a new status in bankruptcy, section 607 cannot do so. The court

24. *E.g.,* INT. REV. CODE of 1954, § 6601(d). Or its interest may be limited in amount. *Id.* at § 6601(b). The Bankruptcy Act disallows interest on tax claims after the date of the petition. 11 U.S.C. §§ 103(a)(1), (5) (1964) (§§ 63(a)(1), (5) of the Act).

The second sentence of section 7501(a) of the Internal Revenue Code of 1954 might encompass minor bankruptcy limitations without embracing the section 64(a) scheme. *Nicholas v. United States,* 384 U.S. 678 (1966), discussed in text accompanying notes 41–42 *infra,* seems to support this view. In *Nicholas,* the Supreme Court clearly felt that interest on a withholding tax claim would stop at the date of a liquidating petition, but declined to determine whether the tax claim would fall within section 64(a) of the Bankruptcy Act.

25. INT. REV. CODE of 1954, § 6501 *et seq.* The Bankruptcy Act provides that tax claims must be filed within six months after the first date set for the first meeting of creditors. 11 U.S.C. § 93(n) (1964) (§ 63(n) of the Act).

26. 48 Stat. 768.

27. Social security tax withholding was authorized in 1935 (ch. 531, Title VIII, § 801, 49 Stat. 636), and income tax withholding was authorized in 1943 (ch. 120 § 2(a), 57 Stat. 126).

28. Rev. Act of 1932, ch. 209, § 751, 47 Stat. 276. The tax was charged to the account of the drawer.

29. Rev. Act of 1934, ch. 277, § 143(b), 48 Stat. 723.

30. Rev. Act of 1932, ch. 209, §§ 701–02, 47 Stat. 270. The tax was billed to the caller. This section also taxed leased facilities.

31. First imposed by the War Revenue Act of 1917 (ch. 63, § 700, 40 Stat. 318).

32. S. REP. No. 558, 73d Cong., 2d Sess. 53 (1934).

33. H.R. REP. No. 1385, 73d Cong., 2d Sess. 32 (1934).

apparently finds that Congress wished to continue its 1926 subordination of tax debts to administrative expenses.[34] Yet, on its face, the section *does* create a trust status; and the legislative history does not in any express way qualify the status which it gives. That a trust fund does not pass to the trustee's general creditors in bankruptcy was first and firmly established in the Bankruptcy Act of 1867,[35] and there seems to be no basis for concluding that Congress did not mean to give the withholdings that character.

The cases cited by the court do not lend much support to its statutory interpretation. The earliest case is In re *Connecticut Motor Lines, Inc.*,[36] a 1964 decision of the Court of Appeals for the Third Circuit. That court's opinion concerned itself primarily with whether the government's claim for withheld income and social security taxes on wages earned prior to bankruptcy, but paid as second-priority claims during bankruptcy, would fall under the first or fourth priority in section 64(a).[37] Only summarily, at the end of the opinion, does the court reject the government's trust fund theory.[38] It does not explain its reasoning any further than to point to the second sentence of section 7501(a). It does not distinguish *United States v. Sampsell*,[39] *Hercules Service Parts Corp. v. United States*,[40] or In re *Airline-Arista Printing Corp.*[41] — all earlier circuit court opinions which had upheld the section 7501(a) trust fund in bankruptcy.

The next case cited by the court is *Nicholas v. United States*.[42] The issue presented in *Nicholas* was whether the trustee in bankruptcy could be compelled to pay the government interest which accrued after the bankrupt's petition for liquidation on sums withheld during a prior Chapter XI arrangement. One of the government's contentions was that the interest on these withheld sums constituted a trust fund which should pass to the government before any distribution to general creditors. It was only this contention which was rejected in *Nicholas*. The Supreme Court expressly declined to determine whether the withheld sums themselves would be subjected to the priorities in section 64(a).[43]

The 1967 memorandum opinion in In re *Green*[44] also contains very little discussion of the reasoning behind its conclusion that the second sentence of section 7501(a) subjects the trust fund to section 64(a)'s priority scheme; it rests on the interpretation given in In re *Connecticut Motor Lines*.[45] Then it proceeds to hold that *even if*

34. *See* 3A W. COLLIER, *supra* note 11, at ¶ 64.01[2.3].
35. 50 YALE L.J. 1268, 1269 (1941). "The inviolable nature of the valid trust is apparently so well-settled that cases involving bankrupt trustees begin with it as an assumption not open to dispute." *Id.* at n.10. *See* Williams v. Jackson, 107 U.S. 478 (1883).
36. 336 F.2d 96 (3d Cir. 1964).
37. The Third Circuit concluded that the government's claim was not for costs and expenses of administration, but was an ordinary tax claim under section 64(a)(4).
38. 336 F.2d at 107.
39. 193 F.2d 154 (9th Cir. 1951).
40. 202 F.2d 938 (6th Cir. 1953).
41. 267 F.2d 333 (2d Cir. 1959), *aff'g per curiam* 156 F. Supp. 403 (S.D.N.Y. 1957).
42. 384 U.S. 678 (1966).
43. 384 U.S. at 691.
44. 264 F. Supp. 849 (D. Colo. 1967).
45. 336 F.2d 96 (3d Cir. 1964).

that interpretation is incorrect, as between section 7501(a) and section 64(a) of the Bankruptcy Act, section 64(a) should prevail. The court makes the unembellished statement that "[w]e can read into § 7501(a) no Congressional intent to repeal, revise, or modify its 'strong' and 'beneficent' policy of subjecting the Government's tax claims to the priorities established by § 64(a) of the Bankruptcy Act."[46] As has been pointed out, one might just as readily take section 7501(a) to mean what it says: it creates a trustee status for the withholder.

II. THE TRUST FUND IN BANKRUPTCY

If the *Halo* court's decision is, in fact, incorrect and if the section 7501(a) trust fund should not be subject to section 64(a) priorities, then what would be its status in bankruptcy? The ordinary rules for cases where a trustee becomes bankrupt would presumably apply. As set out in the comments to section 12 of the Second Restatement of Trusts,

> Although a trustee becomes insolvent or bankrupt, the beneficiary retains his interest in the subject matter of the trust if it can be identified, or in its product if it can be traced into a product, and is entitled thereto as against the general creditors of the trustee.[47]

The bankruptcy court will turn trust property over to its "true" owner, the beneficiary, or to an appointed substitute trustee,[48] before paying even the first priority creditors pursuant to section 64(a).

Tracing presents a serious problem. Although ordered by the court as a debtor-in-possession to set up separate bank accounts for its general, payroll, and tax indebtedness, Halo Metal Products did not do so. There was no way for the government to point to the withheld sums or to show where they had gone. In the usual bankrupt trustee case, this would mean that the beneficiary is reduced to the status of a general creditor.[49]

However, the *Rassner* line of cases cited by the court sets forth an argument against a tracing requirement in the *Halo* situation. In *City of New York v. Rassner*,[50] the Second Circuit was considering a statutory trust declared by the city for sales taxes collected by a restaurant from its patrons. The court admitted that if the "trustee" had mingled collected taxes with his own assets *prior* to bankruptcy, then the city could not recover without tracing.[51] However, where taxes had been collected and mingled during the restaurant's operation as a Chapter XI debtor-in-possession, the court found a tracing requirement undesirable.[52] During a Chapter XI arrangement, a debtor-in-possession

46. 264 F. Supp. at 852. Presumably the court is referring to the subordination first occurring in 1926. *See* note 33 *supra* and accompanying text.
47. RESTATEMENT (SECOND) OF TRUSTS § 12, comment *f* at 37 (1959).
48. *See* note 11 *supra*.
49. RESTATEMENT (SECOND) OF TRUSTS, *supra* note 46, § 202(2); Comment, 32 YALE L.J. 267, 268 (1922). The same principle requires tracing where a principal seeks to reach funds in the hands of his agent or where a bailor seeks to reach funds in the hands of his bailee. *See* note 81–85 *infra* and accompanying text.
50. 127 F.2d 703 (2d Cir. 1942).
51. 127 F.2d at 705.
52. 127 F.2d at 705–06.

is an officer of the court; he is "subject . . . at all times to the control of the court and to such limitations, restrictions, terms, and conditions as the court may from time to time prescribe."[53] Therefore, it ought not to be countenanced that the trustee did not properly perform his job; rather it should be presumed that he did not mingle the trust funds with other monies and that he administered the funds properly. The *Rassner* reasoning with respect to tracing was adopted by the Ninth Circuit in *United States v. Sampsell*[54] and by the Sixth Circuit in *Hercules Service Parts Corp. v. United States*,[55] both cases concerning withheld social security and income taxes. *Rassner* was reaffirmed with respect to those taxes by the Second Circuit in In re *Airline-Arista Printing Corp.*[56]

In addition to these cases, an examination of the nature of this particular trust fund might strengthen an exception to the tracing requirement. The employer holds the funds for no purpose other than the convenience of the government. There is absolutely no excuse for the trustee's mingling of funds with his own assets since he is given no right to deal with them in any way.[57]

III. SECTION 3466 AND SECTION 64(a)

The Seventh Circuit opinion is not founded entirely on statutory interpretation; it further rests on policy arguments. But in arguing policy, the court strains to fit the withheld monies into a class of preferred debts in section 64(a) of the Bankruptcy Act. It includes an argument that non-bankruptcy legislation, when it has attempted to alter the section 64(a) scheme, has been unavailing. For support, the court points to three Supreme Court cases. In *Guarantee Title & Trust Co. v. Title Guaranty & Surety Co.*,[58] the Supreme Court was being asked to construe section 3466 of the Revised Statutes[59] as giving the government a priority greater than that conferred by section 64(a) in collecting, as an entirely unsecured claimant, a debt incurred by the bankrupt on his own account. In *Missouri v. Ross*,[60] the Court was urged to construe section 64 itself to allow a state statute similar to section 3466 to give Missouri a priority it did not have under an ordinary reading of section 64; in *Davis v. Pringle*,[61] the United States

53. 11 U.S.C. § 742 (1964).

54. 193 F.2d 154 (9th Cir. 1951).

55. 202 F.2d 938 (6th Cir. 1953).

56. 267 F.2d 333 (2d Cir. 1959), *aff'g per curiam* 156 F. Supp. 403 (S.D.N.Y. 1957). The district court reconsidered the earlier reasoning in *Rassner* in light of a 1952 amendment to section 64(a)(1) which created a sub-priority for administrative expenses of a liquidating bankruptcy and which superseded an earlier debtor-relief proceeding (*see* note 15 *supra*). It concluded that the amendment neither expressly changed the *Rassner* rule nor evidenced a policy to change it.

57. 26 U.S.C. §§ 3102, 3402 (1964).

58. 224 U.S. 152 (1912).

59. *See* note 13 *supra*.

60. 299 U.S. 72 (1936).

61. 268 U.S. 315 (1925).

argued that section 3466 made its non-tax claim one embraced by section 64's then-fifth priority. Only the *Title Guaranty* plaintiff really attempted to skirt section 64(a) by non-bankruptcy legislation. To agree with that case that, where there is an irreconcilable conflict between non-bankruptcy and bankruptcy legislation, section 64(a) ought to prevail does not, however, mean that one must also agree that section 7501(a) cannot create an effective trust in withheld monies.

There are many cases where the government *has* statutorily succeeded in raising itself above section 64(a)'s priority scheme.[62] Where the government has chosen to give itself lienor status,[63] it has not successfully been argued that there is any irreconcilable conflict with section 64(a). Section 64(a) is only one part of the Bankruptcy Act; it applies only where a claim is unsecured; it has never purported to dictate distribution apart from other sections of the Bankruptcy Act. Section 70(a)[64] may allow some property to escape the trustee and general creditors completely: secured creditors will be allowed to satisfy claims from their security,[65] and ordinarily property held by the bankrupt as trustee will be turned over to its beneficial owner[66] — all before section 64(a) begins to take effect.

The policy trends which form the third of the *Halo* court's arguments against the trust fund[67] are again, unfortunately, limited entirely to section 64(a). The court has not given consideration to wider policy which would embrace secured claims.

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62. *E.g.*, United States v. White Bear Brewing Co., 350 U.S. 1010 (1956); United States v. Gilbert Associates, Inc., 345 U.S. 361 (1953); United States v. Security Trust & Sav. Bank, 340 U.S. 47 (1950).

63. The federal government's lien status is defined in INT. REV. CODE of 1954, §§ 6321-23.

64. 11 U.S.C. § 110(a) (1964).

65. *See In re* Meisel, 159 F. Supp. 879, 881 (D. Md. 1958). Section 57(h) of the Bankruptcy Act, 11 U.S.C. § 93(h) (1964), providing for such satisfaction, can be traced back to section 20 of the 1867 Act. 3 W. COLLIER, *supra* note 11, at ¶ 57.01[1.3].

66. *See* note 11 *supra*.

67. The court traces two parallel lines of statutory development, one reducing and limiting the priority accorded to taxes and the other giving increasingly favorable treatment to administrative expenses:

1) Until 1926 taxes held the first priority in bankruptcy; in 1926 they were reduced to the sixth priority. This position was retained in the 1938 Chandler Act, although renumbering and consolidation made the priority fourth. The Chandler Act made taxes subject, for the first time, to the general limitation period for filing claims. The Supreme Court's decision in City of New York v. Saper, 336 U.S. 328 (1949), removed the exemption of tax claims from the general prohibition of post-bankruptcy interest. Finally, in 1964, section 64(a)(4) was amended to give fourth priority only to taxes not released by a discharge in bankruptcy (and section 17(a)(1) was amended to make all tax claims dischargeable except those accruing within three years preceding bankruptcy).

2) Until 1926 administrative expense claims were subordinate to tax claims; in 1926 they were placed ahead of tax claims while remaining subordinate to claims of the referee and of the creditors for costs of recovering or preserving assets. In 1938 costs and expenses of administration were placed in the first priority category, sharing pro rata with recovery and preservation costs. In 1952 the administrative expenses of a liquidating bankruptcy were given a sub-priority to those of a superseded debtor-relief proceeding.

IV. ATTACK ON STATUTORY PRIORITIES

Criticism has been directed toward attempts by governmental entities to raise their own status in insolvency, and that of favored groups,[68] by the simple device of a legislative enactment.[69] The criticism has been most effective when directed at state legislation.[70] Because of our federal system, a state enactment which is regarded as frustrating a federal one — like the Bankruptcy Act — must fall. On the other hand, it is hard to argue that the federal government cannot give itself whatever priorities it finds appropriate[71] (and by a mere shuffling of words like "lien" or "trust fund"); what it leaves for other creditors might be looked upon as a matter of grace.

The declaration of a lien is a recognized device for raising a creditor's place in the line of distributees in insolvency. Under section 67(b)[72] of the Bankruptcy Act, certain statutory liens may be valid even when acquired within four months of bankruptcy.[73] Early bankruptcy legislation allowed statutory liens to consume the bankrupt's estate. The astonishing variety of liens being created and the mounting criticism from competing creditors led to important changes in the Bankruptcy Act.[74] Liens not good against a bona fide purchaser were invalidated.[75] Even as to validly recorded tax liens, in order to insure payment of administrative expenses and small wage claims, section 67(c)(3) now reads, "[E]very tax lien on personal property not accompanied by possession shall be postponed in payment to the debts specified in clauses (1) and (2) of subdivision a of section 64 of this Act. . . ."[76] Congress has agreed that the declaration of a lien — be it state or federal — ought not to have the effect of magic words; it must be a bona fide lien and not a disguised priority with no foundation in fact.

As to the trust fund, it is a less familiar, but similar, device.[77] Policy could be said to require that the government's declared "trust" not be allowed to carry away assets from other claimants, and especially

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68. For example, laborers, materialmen, subcontractors, and landlords.

69. *See, e.g.*, Smith, *Title and the Right to Possession Under the Uniform Commercial Code*, 10 B.C. IND. & COM. L. REV. 39, 54–55 (1968); 40 IND. L.J. 233 (1965); 50 YALE L.J. 1268 (1941).

70. Since 1938 state-created priorities have not been honored in bankruptcy. 4 W. COLLIER, *supra* note 11, at ¶ 67.20[2]. In Elliott v. Bumb, 356 F.2d 749 (9th Cir. 1966), a California statute created a trust for the benefit of a principal in funds received by a credit agent in the sale of checks and money orders. The statute did not require tracing. The Ninth Circuit found that the statute was ineffective to set up a priority in bankruptcy.

71. The Constitution gives Congress power to establish "Uniform Laws on the subject of Bankruptcies throughout the United States." U.S. CONST. art. I, § 8.

72. 11 U.S.C. § 107(b) (1964). This section applies to statutory liens in favor of employees, contractors, mechanics, and other classes of persons and to certain taxes and debts owing to the United States or any state.

73. A lien acquired by attachment, judgment, levy, or other legal or equitable process within four months of bankruptcy is generally invalid. 11 U.S.C. § 107(a) (1964) (§ 67(a) of the Act).

74. *See* 4 W. COLLIER, *supra* note 11, at ¶ 67.02[3].

75. 11 U.S.C. § 107(c)(1)(b) (1964).

76. 11 U.S.C. § 107(c)(3) (1964).

77. The likeness is pointed out elsewhere. *See* Elliott v. Bumb, 356 F.2d 749 (9th Cir. 1966); 4 W. COLLIER, *supra* note 11, at ¶ 67.25[2]; 50 YALE L.J. 1268, 1271 (1941).

from claimants falling into subdivisions (1) and (2) of section 64(a), unless the trust has a rational basis in fact. If the analogy to a lien is carried through, the government ought to allow subordination of its trust claim whenever the trust has no such basis.

It can be argued that there is a certain falsity to any trust fund claim. As alluded to in the tracing discussion,[78] there is no identifiable "fund" at all. In fact, no money has ever been deposited with the debtor by a third person. Unlike an ordinary trustee, an employer like Halo has received only a credit or deduction from what it has had to pay out to its employees. On the other hand, one might say that Halo has received a quantity of labor rendered by its employees for the benefit of the government. In this sense, Halo's asset-liability balance has been favorably affected by the withholding scheme. Its assets *have* been swelled. Halo, as tax collector, assumes the character of a conduit.[79] It has been remarked, in support of the validity in bankruptcy of state statutory trusts imposed upon sales taxes collected by the retailer, that the taxes "are related only superficially to the retailer's normal economic activity, and the Bankruptcy Act is only concerned with the equitable distribution of the ordinary fruits of that activity."[80] The swelling of Halo's assets is due to the withholding scheme and is not "ordinary fruit" of Halo's business activity.

The bankrupt's position in collecting or withholding the taxes, absent any statutory characterization as that of trustee, might be seen as that of a bailee or agent for the government.[81] Collier defines a bailment as "a delivery of goods for some purpose, upon a contract express or implied to be redelivered to the bailor upon fulfillment of the purpose or to be dealt with according to the bailor's direction";[82] he defines an agency as "a relationship arising from a contract, express or implied, by which one of the parties confides to the other the transaction or management of some business or other activity in his name, or on his behalf, and whereby the other party assumes so to act and to render an account thereof."[83] It would not be stretching these definitions unduly to view the employer as a bailee or collecting agent for the government. It is well settled that, as a general rule, if property is in a bankrupt's hands as bailee or agent, the trustee will not take title to it under section 70(a)(5);[84] but the bailor or principal may recover the property or its proceeds.[85]

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78. *See* notes 49–57 *supra* and accompanying text.

79. *Cf.* Rivard v. Bijou Furniture Co., 67 R.I. 251, 21 A.2d 563 (1941); 40 IND. L.J. 233, 238 (1965).

80. 40 IND. L.J. 233, 238 (1965).

81. *Cf.* Elliott v. Bumb, 356 F.2d 749, 754 (9th Cir. 1966).

82. 4A W. COLLIER, *supra* note 11, at ¶ 70.18[4].

83. *Id.* For elaboration of the duties of a collecting agent, see RESTATEMENT (SECOND) OF AGENCY § 427 (1957).

84. 11 U.S.C. § 110(a)(5) (1964).

85. *In re* Klein, 3 F.2d 375 (2d Cir. 1924); Smith Wallace Shoe Co. v. Ternes, 235 F. 282 (8th Cir. 1916); *In re* John J. Kingsley, Inc., 8 F. Supp. 303 (D. Mass.), *aff'd sub nom.*, Nathanson v. Worcester Bank & Trust Co., 73 F.2d 889 (1st Cir. 1934); 4A W. COLLIER, *supra* note 11, at ¶ 70.18[4]. Tracing is required. *See* note 49 *supra*.

All these aspects of the withholding tax situation refute arguments that the section 7501(a) trust fund is a mere disguised priority. Retention of bare legal title in the bankrupt is certainly not grossly out of place.[86] Like a lien which has attached to specific property, the trust has a basis in fact.

V. CONCLUSION

The opinions which have attempted to give a place in bankruptcy to the trust fund under section 7501(a) have never fully analyzed the problem. They have not considered the many ways that the withholdings can be viewed; nor have they bothered to analogize or distinguish bankruptcy situations which are comparable — bailor, agent, or secured creditor status. The main weakness of the Seventh Circuit's decision in *Halo* seems to lie in its ready acceptance of the conclusion in In Re *Connecticut Motor Lines, Inc.* that the second sentence of section 7501(a) subjects the trust fund to the bankruptcy priorities in section 64(a). Despite the fact that the later portions of the opinion are prefaced by the words "even if we accept *arguendo* the Government's position that Section 7501(a) is intended to grant trust fund taxes a higher priority in bankruptcy than they are allowed by section 64(a)(1) of the Bankruptcy Act,"[87] the court continues, as if wearing blinders, to regard the government's status as falling within section 64(a).

It may well be that it would be in accord with present views on government priority to subordinate the federal claim in *Halo* to payment of administrative expenses. It might be time for bankruptcy legislation which will deal with the trust, just as section 67 has dealt with liens. But as the law stands, any final solution to the question of the trust fund's status would require consideration of many more aspects of the situation than have been dealt with to date.

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86. 40 IND. L.J. 233, 238 (1965).

87. 419 F.2d at 1072.