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Should the Sovereign be Paid First?
A Comparative International Analysis
of the Priority for Tax Claims
in Bankruptcy

by

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[461] As the free market economy becomes more global in scope, with developed countries continuing to expand free trade policies and transition countries introducing reforms to create market economies, increased attention has been given to the need for effective insolvency and bankruptcy laws.

This trend is apparent in the work of the major international financial institutions assisting the transition countries. The International Monetary Fund's Legal Department recently published a report, *Orderly & Effective Insolvency Procedures--Key Issues*, which discusses and makes recommendations regarding the "major policy choices to be addressed by countries when designing an insolvency system."¹ Similarly, the World Bank announced last year that, "as part of the wider effort to improve the future stability of the international financial system," it is "leading an initiative to identify principles and guidelines for sound insolvency systems and for the strengthening of related debtor-creditor rights in emerging markets."²

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¹LEGAL DEPARTMENT, INTERNATIONAL MONETARY FUND, *ORDERLY & EFFECTIVE INSOLVENCY PROCEDURES: KEY ISSUES* vii (1999), available at <<http://www.imf.org/external/pubs/ft/orderly/index.htm>> (last visited Nov. 29, 2000) [hereinafter IMF REPORT].

²THE WORLD BANK, *BUILDING EFFECTIVE INSOLVENCY SYSTEMS*, available at <http://www1.worldbank.org/legal/insolvency_ini/overview.htm> (last visited Nov. 29, 2000).

Although much excellent and thoughtful work has been done in this process, one part of an effective insolvency law has not received specific attention: the interaction between bankruptcy and tax laws. Yet a transition country attempting to develop an effective bankruptcy system must confront [462] several questions raised by this intersection. The fundamental question, of course, is whether enforcement of tax claims should be subject to the country's insolvency laws. If the insolvency law is extended to tax claims, a series of questions arises regarding whether and to what extent payment of tax claims should be afforded priority treatment.

How these questions are resolved will be influenced by, among other things, the structure of the country's tax system and the policies underlying it, the existing enforcement system embodied in the tax laws, the goals of the insolvency system and the policies reflected in it (including the significance of business rehabilitation as an economic policy goal), and the potentially conflicting policies of the assisting international agencies and private lenders.

This Article attempts to shed some light on these issues by comparing the treatment afforded tax claims under the national insolvency laws of (1) England, (2) Australia, (3) New Zealand, (4) Canada, (5) the United States, (6) Germany, (7) France, and (8) Mexico. These countries include both civil and common law jurisdictions, with bankruptcy systems that cover the range from pro-creditor to pro-debtor--Australia and Germany having the most pro-creditor laws and Mexico and France having the most pro-debtor laws.³ All of the countries have reformed their insolvency laws within the last twenty-five years.

Historically, each of these countries has granted favored treatment to the government's claims in the event of a taxpayer's insolvency. Part I of this Article discusses the origin of these tax priority rules and their policy justifications.

Part II describes recent criticism of the priority rules and efforts to refine, limit, or abolish tax priorities in bankruptcy.

Part III describes the current treatment of tax claims in insolvency proceedings in the eight listed countries. Because an understanding of both tax and insolvency law is necessary to understand how the two systems interact, Part III begins with a brief overview of these laws, including a description of both the types of taxes countries impose and the procedures that can be used to collect and enforce taxes in the absence of a collective insolvency proceeding.

Part IV compares the different approaches that have been adopted in these eight countries, and draws conclusions about the choices that have been made.

Finally, Part V suggests issues to be considered in evaluating and designing rules for the treatment of tax claims in insolvency proceedings.

³PHILIP R. WOOD, PRINCIPLES OF INTERNATIONAL INSOLVENCY 4-7 (1995) (scaling of jurisdictions according to whether their corporate insolvency laws are pro-debtor or pro-creditor, based on a number of factors).

[463] I. TAX PRIORITY RULES: ORIGINS AND JUSTIFICATIONS

The government's favored treatment for its revenue claims is of ancient origin. In England, the Crown prerogative dates from feudal times. It entitled the monarch to an absolute priority for revenue-related debts upon the insolvency of an English subject.⁴ As English common law was exported to other parts of the world, the idea that the government was entitled to priority for its revenue claims found expression even in the absence of a monarch. Thus, in 1789, at a time when the revenues of the United States derived primarily from customs duties and whiskey taxes, one of Congress's first legislative acts was to grant the new federal government the right to be paid first when a person indebted to the United States became insolvent.⁵

Traditionally, there have been several justifications for the priority for tax claims. First, unlike the claims of private commercial creditors, tax claims are for the benefit of the entire community. The priority protects the revenue base for the common good,⁶ and avoids shifting the burden of the debtor's unpaid taxes to other taxpayers.⁷

⁴The history of the Crown priority in common law countries goes back to the Magna Carta, where it was said that "The King's Debtor dying, the King shall be first paid." Magna Carta (Confirmed version), 9 Henr. III, 1225, C. 18. At common law the Crown had a prerogative right to be paid first and, in Canada, the Crown continued to assert its prerogative after the enactment of the first Canadian bankruptcy acts on the ground that a statute could not bind the Crown. REPORT OF THE STUDY COMMITTEE ON BANKRUPTCY AND INSOLVENCY LEGISLATION ¶ 3.2.075, at 122 (1970) (Can.) [hereinafter TASSÉ REPORT (Can.)].

⁵1 Stat. 42 (1789) ("In all cases of insolvency, . . . the debt due to the United States on [bonds for the payment of duties] shall be first satisfied."). This federal priority statute is now codified as 31 U.S.C. § 3713. By its terms, however, it is not applicable in bankruptcy cases.

⁶NEW ZEALAND LAW COMMISSION, STUDY PAPER 2, PRIORITY DEBTS IN THE DISTRIBUTION OF INSOLVENT ESTATES ¶ 98, at 30 (1999) [hereinafter STUDY PAPER (N.Z.)] ("Priority is necessary to protect the revenue. Without priority, the burden of taxation would fall unfairly on solvent taxpayers."); REPORT OF THE REVIEW COMMITTEE, INSOLVENCY LAW AND PRACTICE, 1982, Cmnd. 8558, ¶ 1409, at 320 (Eng.) [hereinafter CORK REPORT (Eng.)] ("it has been represented to us that sums due in respect of unpaid tax ought to have priority, . . . because they are owed to the community"); 1 AUSTRALIAN LAW REFORM COMMISSION, REPORT NO. 45, GENERAL INSOLVENCY INQUIRY ¶ 734, at 299 (1988) [hereinafter HARMER REPORT (Austl.)] (Arguments put forth in favor of the priority include that "taxation debts are owed to the community rather than an individual" and "the revenue of the Crown must be protected."); Alain David, *Preferences of the Tax Authorities and Bankruptcy Law in France*, in CORPORATE INSOLVENCY AND RESCUE: THE INTERNATIONAL DIMENSION 221, 227 (Dennis Campbell and Anthony E. Collins eds., 1993) ("Primacy of the preference of the tax authorities . . . is justified by the idea that the claims of tax authorities are collective claims concerning the community and which must, therefore, take precedence over the specific interest of each creditor."); WOOD, *supra* note 3, at 23-24 ("the arguments put forward by tax authorities for the priority of their claim is traditionally that the public interest comes before the private interest"); David Lacey, *Preferential Claims of Government in English Insolvency Proceedings*, in CORPORATE INSOLVENCY AND RESCUE: THE INTERNATIONAL DIMENSION, *supra*, at 43, 45 ("There is a moral duty owed to the community to contribute one's fair share of the tax burden.").

⁷SENATE COMM. ON THE JUDICIARY, TO ACCOMPANY S. 2266, S. REP. NO. 95-989, at 14 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5800 [hereinafter SENATE REPORT (U.S.)] ("To the extent that debtors in a bankruptcy are freed up from paying their tax liabilities, the burden of making up the revenues thus lost must be shifted to other taxpayers."); Elizabeth Warren, *Bankruptcy Policymaking in an Imperfect World*, 92 MICH. L. REV. 336, 361-62 (1993) ("The bankruptcy laws are organized to minimize losses to the general public when a business fails and to

[464] Second, unlike private creditors, taxing authorities are involuntary creditors, unable to choose their debtor or obtain security for debt before extending credit.⁸ The priority compensates for this disadvantage, giving the taxing authorities an opportunity to assess the amounts due and mobilize their collection remedies.⁹

Third, with regard to taxes for which the debtor acts as the government's tax collector--such as sales tax, value added tax, or employee withholding tax--the argument is made that, if no priority or trust is imposed, the moneys collected by the debtor will increase the estate for the benefit of unsecured creditors. In these circumstances, the tax priority operates to prevent a windfall to general unsecured creditors who have no fair claim to the collected funds.¹⁰

force parties dealing with the failing debtor to bear the burden of the failure. . . . Bankruptcy policy minimizes losses to the public fisc in an obvious way: it requires payment first and in full to government taxing authorities.").

⁸STUDY PAPER (N.Z.), *supra* note 6, ¶ 98, at 31 ("The Commissioner of the Inland Revenue is an involuntary creditor."); CORK REPORT (Eng.), *supra* note 6, ¶ 1409, at 320 ("It has been represented to us that sums due in respect of unpaid tax ought to have priority, . . . because Revenue, unlike others who give credit, is an involuntary creditor."); HARMER REPORT (Austl.), *supra* note 6, ¶ 734, at 300 ("The Commissioner is an involuntary creditor and is not in a position to make a choice about extending credit to taxpayers."); TASSÉ REPORT (Can.), *supra* note 4, ¶ 3.2.075, at 122 ("[The Crown] continued to assert the necessity of a priority in its favour, on the ground that the Crown was invariably, certainly in respect of taxes, an unwilling creditor and could not choose its debtor."); HOUSE COMM. ON THE JUDICIARY, TO ACCOMPANY H.R. 8200, H.R. REP. NO. 95-595, at 190 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6150 [hereinafter HOUSE REPORT (U.S.)] ("A taxing authority is given preferred treatment because it is an involuntary creditor of the debtor. It cannot choose its debtors, nor can it take security in advance of the time that taxes become due."); Lacey, *supra* note 6, at 44-45 ("The vast majority of Government claims arise in a manner which has few direct counterparts in the private sector, that is by reference to acts of, or circumstances affecting, its citizens and over which it has little advance control. . . . One of the most obvious examples of this is liabilities which arise as a result of the imposition of Value Added Tax on sales. The Government has no control over whether a person does or does not sell an item . . . but upon the sale being made an obligation to pay [the] tax may arise. Likewise, the Government has little control over when and how an individual earns money, but such an individual may nonetheless be liable to pay tax on those earnings." Requiring the business to collect the taxes for the government "represents a considerable saving to the Government in terms of bureaucratic overhead but involves the Government taking a credit risk on the solvency of its unpaid tax collectors."); WOOD, *supra* note 3, at 23-24 ("The arguments put forward by tax authorities for the priority of their claim is traditionally . . . that they are involuntary creditors.").

⁹SENATE REPORT (U.S.), *supra* note 7, at 14 ("A three-way tension thus exists among (1) general creditors, who should not have funds exhausted by an excessive accumulation of taxes for past years; (2) the debtor, whose 'fresh start' should likewise not be burdened with such an accumulation; and (3) the tax collector, who should not lose taxes which he has not had a reasonable time to collect or which the law has restrained him from collecting.").

¹⁰STUDY PAPER (N.Z.), *supra* note 6, ¶ 98, at 31 ("Some of the debts, . . . represent moneys payable by the debtor to the Commissioner on behalf of another person. Thus, it is argued that there is an analogy with the law of trusts so that the debts should be afforded priority even though the monies may have been mingled with other fungibles, and are therefore no longer traceable."); CORK REPORT (Eng.), *supra* note 6, ¶ 1418, at 321 (Involuntary creditor argument is more persuasive for taxes that are "collected by the debtor, whether by deduction or charge, and for which the debtor is accountable to the Crown; the debtor is to be regarded as a tax collector rather than a taxpayer. Unless some measure of priority were accorded to the Crown for moneys collected on its behalf, or they were to be regarded as impressed with a trust, [the moneys] would go to swell the insolvent's estate to the advantage of the general body of creditors. We cannot think it right that statutory provisions enacted for the more convenient collection of the revenue should enure to the benefit of private creditors."); HARMER REPORT (Austl.), *supra* note 6,

[465] Fourth, some argue that if the taxing authorities are not reasonably secure they will be discouraged from negotiating payment terms with debtors, thus forcing premature and possibly unnecessary business failures.¹¹

Finally, it can be argued that the priority is needed to effectuate an individual debtor's discharge, where tax liabilities are made nondischargeable in order to discourage tax evasion through bankruptcy. Granting priority to those nondischargeable tax debts supports the individual debtor's rehabilitation, making it more likely that the tax claims will be paid in a personal bankruptcy and that the debtor will be left with fewer nondischargeable debts at the conclusion of the proceeding.¹²

II. CRITICISM OF PRIORITY RULES AND REFORM EFFORTS

The impact of the tax priority has increased in recent times because of generally increasing levels of taxation.¹³ Types of "direct" taxes now include [466] taxes on corporate and personal income or gross receipts; ad valorem taxes on land, buildings and personal property; payroll and social security taxes; a variety of excise taxes; and customs duties. "Indirect" taxes, where the debtor acts as tax collector for the government, include sales or value added tax and income tax

¶ 734, at 300 ("It would be contrary to public policy to allow a person authorised to make deductions to use the money deducted to meet ordinary trade debts.").

¹¹WOOD, *supra* note 3, at 23-24 ("The arguments put forward by tax authorities for the priority of their claim is [sic] traditionally . . . that if they were not reasonably secure, they would be obliged to bankrupt companies earlier than necessary and thereby incur much opprobrium."); REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. DOC. NO. 93-137, AT 216 (1ST SESS. 1973), *reprinted in* B Collier on Bankruptcy, app. pt. 4(c), at 484 (15th ed. rev. 1999) [hereinafter BANKRUPTCY COMMISSION REPORT (U.S.)] (noting that the Treasury Department had previously argued that it "would be required to harass and embarrass taxpayers in many cases where accommodation would be possible but for the three-year limit.").

¹²HOUSE REPORT (U.S.), *supra* note 8, at 190 ("Because it takes a taxing authority time to locate and pursue delinquent tax debtors, taxes are made nondischargeable if they become legally due and owing within three years before bankruptcy. An open-ended dischargeability policy would provide an opportunity for tax evasion through bankruptcy, by permitting discharge of tax debts before a taxing authority has an opportunity to collect any taxes due. The priority is tied to this nondischargeability provision, in order to aid the debtor's fresh start. By granting the nondischargeable tax a priority, more of it will be paid in the bankruptcy case, leaving less of a debt for the debtor after the case.").

¹³David, *supra* note 6, at 221 ("The balance between ordinary creditors and those holding some type of preference or security has rapidly deteriorated, naturally to the detriment of the former. The reasons for this are numerous and well known, reflecting the economic, political and social evolution of the 20th century. . . . The Treasury has seen its right of preference increased, not only through the multiplication of the number of taxes but also the widening of their base. . . . If to this is added the social security debt, one understands that the preferential claims by the tax and social security Authorities very generally exhaust whatever assets remain in the business and, at the same time, destroy any hope for the other creditors to obtain any payment whatsoever."); TASSÉ REPORT (Can.), *supra* note 4, ¶ 3.2.077, at 123 ("The cumulative impact of the [Crown] priority has substantially increased since the Second World War. Crown priorities have grown in three dimensions: (1) the rates of existing or old taxes have been increased; (2) there have been many new kinds of taxes; and (3) the Crown has become extensively engaged in business, particularly through the use of Crown corporations to which the Crown priority has been held, in many cases, to apply.").

withheld for domestic employees and foreign taxpayers. Taxes often are imposed on both the national and local level.

As new forms of taxation have been created and tax rates have increased, tax claims have consumed more and more of an insolvent debtor's estate, leading to questions about the tax priority. Critics of the priority reject the community interest argument, contending that the debt owed to the government is unlikely to be significant in terms of total government receipts, whereas the loss to private creditors may cause substantial hardship and precipitate additional insolvencies.¹⁴ Moreover, to the extent private creditors receive a higher return on their claims, part of the loss to the taxing authorities can be recouped through additional taxes paid by those creditors.¹⁵ And, of course, a loss of priority does not prevent the taxing authorities from sharing [467] in an insolvent estate pro rata with general unsecured creditors.¹⁶

Critics of the priority similarly reject the involuntary creditor argument, on the ground that the government has other enhancements of its ability to collect debts, offsetting its involuntary position, that are not shared by private creditors, including (1) the imposition of penalties and

¹⁴STUDY PAPER (N.Z.), *supra* note 6, ¶ 99, at 31 ("The Crown is better able to absorb debt than many traders."); BANKRUPTCY COMMISSION REPORT (U.S.), *supra* note 11, at 216 (Based on statistical information, the Commission believed that the amount of revenue lost as a result of 1966 amendments reducing the period for tax priorities to three years did not appear to be significant.); CORK REPORT (Eng.), *supra* note 6, ¶ 1410, at 320. ("We unhesitatingly reject the argument that debts owed to the community ought to be paid in priority to debts owed to private creditors. A bad debt owed to the State is likely to be insignificant in terms of total Government receipts; [whereas] loss of a similar sum by a private creditor may cause substantial hardship, and bring further insolvencies in its train."); HARMER REPORT (Austl.), *supra* note 6, ¶ 735, at 301 ("Taxation debts of insolvents are insignificant in terms of total government receipts but the amount foregone by a private creditor may be the difference between the creditor surviving or failing. The net loss to the Commissioner from the abolition of the priority would be insignificant."); TASSÉ REPORT (Can.), *supra* note 4, ¶ 3.2.076, at 122-23 ("It must be determined whether [the Crown] priority is justified in a modern society. Certainly, it is not necessary for the financial stability of the government. . . . It could even be argued that the government should rank after ordinary creditors, as the public treasury is, in fact, in a better position than anyone to bear the inevitable losses. The government can, in effect, divide the burden of tax left unpaid by the bankrupt among all the tax paying public. It would be more logical for the government to do this, than to . . . reimburse itself, at the expense of the creditors who have already suffered losses."); ADVISORY COMMITTEE ON BANKRUPTCY AND INSOLVENCY, REPORT OF THE ADVISORY COMMITTEE ON BANKRUPTCY AND INSOLVENCY 79 (1986) (Can.) [hereinafter COLTER REPORT (Can.)] ("The burden of tax left unpaid by the bankrupt should be divided among all the tax-paying public rather than borne by the creditors, who have already suffered losses.").

¹⁵CORK REPORT (Eng.), *supra* note 6, ¶ 1416, at 321 ("It has not been suggested to us that the net loss to the Revenue would be significant if Crown preferences were abolished. A substantial proportion of the tax lost would no doubt be recouped from the increase in dividends payable to ordinary commercial creditors, thereby reducing the amount of bad debts written off by them against trading profits."); BANKRUPTCY COMMISSION REPORT (U.S.), *supra* note 11, at 216 ("The small loss of revenue as a result of the Commission's recommendations will be offset, perhaps to the extent of 50%, by a reduction in the amount of bad debt deductions taken by the other creditors.").

¹⁶TASSÉ REPORT (Can.), *supra* note 4, at 123-24 n.46 ("To measure the loss of revenue to the government due to the abolition of the Crown priority in a given year, it would be necessary to ascertain the total dividends paid to the government in that year and then deduct from this the sum it would have received as an ordinary creditor."); HARMER REPORT (Austl.), *supra* note 6, ¶ 735, at 301 ("The loss of revenue resulting from abolition of the priority would be partially offset by the Commissioner receiving a proportion of the general distribution of the insolvent estate." (footnote omitted)).

relatively high interest rates, (2) third party liability, and (3) collection procedures such as statutory lien and levy.¹⁷ Furthermore, there is no general rule that involuntary creditors should receive priority--several other categories of involuntary creditors are not entitled to any kind of priority.¹⁸

Critics also argue that abolishing priority for tax claims will provide a greater incentive to the taxing authorities to collect taxes in a commercially reasonable manner, by removing reliance on an artificial ability to be paid ahead of other creditors.¹⁹ These critics reject the argument that priority can be beneficial to the rehabilitation process and argue instead that any incentive [468] to delay collection is counterproductive. According to this view, delaying collection compromises the uniform enforcement of the tax laws and constitutes a state subsidy, which undermines the disciplinary force of an effective insolvency law.²⁰ Particularly in situations where the debtor is acting as tax collector, the taxing authorities have better information available about the debtor's financial condition than general business creditors. The debtor is required to submit periodic returns in connection with payroll, value added taxes, sales taxes, and taxes withheld from employee wages, and the authorities receiving these returns are likely to know without delay when there is a delinquency.²¹ Allowing tax debts to accumulate under those

¹⁷STUDY PAPER (N.Z.), *supra* note 6, ¶ 99, at 31-32 ("It is inherently unfair for the Commissioner to have a priority over other unsecured creditors because: - the provisions of the Tax Administration Act 1994 and other revenue statutes provide the Crown with remedies that facilitate the collection of debts, whereas similar procedures are not available to ordinary creditors; - the Commissioner has significant powers to impose penalties for nonpayment of tax. Interest rates also apply at much higher rates than would be awarded if a creditor sought to recover a debt in court; - the Commissioner has the power to require a third party to pay a debt from monies held on behalf of a taxpayer; and - the Commissioner can seek orders from the High Court for the recovery of tax even though no judgment may have been entered against the debtor." (footnotes omitted)); CORK REPORT (Eng.), *supra* note 6, ¶ 1413, at 320 ("In recent years, the Revenue's position has been greatly strengthened by the granting by Parliament of additional powers to raise assessments and to charge interest on unpaid or late paid tax. It has powers to impose penalties, and possesses remarkable powers to enable it to obtain information, including where necessary powers of entry, search and seizure. HM Customs and Excise enjoy even more extensive powers.").

¹⁸TASSÉ REPORT (Can.), *supra* note 4, ¶ 3.2.076, at 123-24 ("Individuals claiming damages do not choose their debtors either; and yet, they do not benefit by a priority rank. One wonders whether, in our economy of easy credit, the businessman has always the economic freedom to choose his debtor or whether he is not bound, to a certain point, to give credit to the same extent as do his closest competitors."); CORK REPORT (Eng.), *supra* note 6, ¶ 1414, at 321 ("The Crown is not alone in being an involuntary creditor. Many suppliers of goods and services are constrained to extend credit facilities in accordance with the custom of the trade. In a practical sense they have no real choice in the matter, and are sometimes unable to exercise credit control. Many other categories of involuntary creditor may readily be called to mind: litigants who obtain judgments for costs, for example, and the victims of breach of contract and tort do not normally extend credit voluntarily to their debtors."); WOOD, *supra* note 3, at 23-24 ("the arguments put forward by tax authorities for the priority of their claim is traditionally that . . . they are involuntary creditors (but so are tort claimants)").

¹⁹HARMER REPORT (Austl.), *supra* note 6, ¶ 735, at 300 ("The Commissioner's priority assures the Taxation Department of payment and it consequently is under no pressure to recover it in a normal commercial manner.").

²⁰IMF REPORT, *supra* note 1, at 49.

²¹STUDY PAPER (N.Z.), *supra* note 6, ¶ 99, at 31 ("In the case of PAYE [Pay As You Earn] and GST [Goods and Services Tax], the Commissioner receives regular returns from taxpayers (or at least should know if a regular return has not been made) which give the Commissioner more information on which to base a decision to take action to collect arrears than most trade creditors would have." (emphasis in original)).

circumstances can unfairly disadvantage other unsecured creditors who go on trading with the debtor not knowing that there is a tax delinquency.²²

Swayed by these considerations, committees and commissions appointed in industrialized countries to review insolvency laws over the last forty years have recommended uniformly that tax priorities be limited or abolished.²³ [469] The lawmakers generally have responded favorably to these recommendations, some more aggressively than others.²⁴ Most recently, in October

²²HARMER REPORT (Austl.), *supra* note 6, ¶ 735, at 300-01 ("The Commissioner, by allowing taxation debts to accumulate without real risk to the Commissioner's position, may seriously disadvantage the interests of other unsecured creditors. . . . Other creditors will not be privy to this information and may be ultimately disadvantaged if the business later goes into liquidation." (footnote omitted)); IAN F. FLETCHER, *THE LAW OF INSOLVENCY* 293 (2d ed. 1996) ("Since a person's tax affairs are necessarily a confidential matter, other parties may become ordinary, unsecured creditors of the debtor at a time when, despite outward appearances to the contrary, he is already hopelessly insolvent due to the extent of his fiscal liabilities.").

²³*England* - CORK REPORT, *supra* note 6, ¶ 1450, at 328-29 (recommending abolition of priority for income, corporation, and capital gains tax, but retention of priority for certain quasi-trust debts such as VAT and PAYE, with the period for such preferences reduced); *Australia* - HARMER REPORT, *supra* note 6, ¶¶ 741-43, at 303-04 (recommended abolishing priority for withholding type taxes, noting "over-whelming support for total abolition," as well as abolishing priority for State, Territory, and local taxes, noting that "municipal and local rates and land tax will generally be a charge or otherwise secured over the land and on this basis the specific priority is unnecessary"); *Canada* - TASSÉ REPORT, *supra* note 4, ¶ 3.2.079, at 123 ("In our opinion, the priority of the Crown in our modern society cannot be justified and we recommend that it be abolished."). COLTER REPORT, *supra* note 14, ¶ 68, at 10-11 ("The priority of the Crown should be totally abolished under both federal and provincial jurisdiction, and all claims of the Crown should rank in the same priority as unsecured creditors. The elimination of the Crown priority should include all provincial and federal legislation purporting to give priority by way of security, statutory trust or lien or otherwise for any debt not contractually incurred."); *United States* - BANKRUPTCY COMMISSION REPORT, *supra* note 11, at 215-16 (recommending limiting tax priorities to taxes withheld from wages and one year's taxes for (1) income taxes, (2) ad valorem taxes, (3) employment taxes due on wages paid by debtor, and (4) customs duties and excise taxes, and that statutory tax liens not be recognized in bankruptcy except for liens against property securing a tax of general application based on the value of the property or a special assessment imposed upon the property by any taxing authority if the assessment was imposed for the purpose of defraying the cost of a public improvement.); *Germany* - Klaus Kamlah, *The New German Insolvency Act: Insolvenzordnung*, 70 AM. BANKR. L.J. 417, 420 (1996) ("In 1985, a Commission formed by the Minister of Justice . . . proposed . . . the abolition of all priority debts.").

²⁴*England* - FLETCHER, *supra* note 22, at 293 ("Reforms were implemented to abolish the Crown's privileged position as a preferential creditor for unpaid taxes assessed directly upon the insolvent debtor (individual or corporate) as taxpayer to the Inland Revenue, and also to abolish the preferential status formerly accorded to local rates. A further change in the law had the effect of restricting Crown preference in respect of outstanding payments of Value Added Tax to a period of six months, as against the period of 12 months which is applicable for other debts due to Customs and Excise. . . . [These reforms] symbolise an important change of attitude towards the traditional categories of preferential debt, whose status can no longer be regarded as sacrosanct."); *Australia* - HARMER REPORT, *supra* note 6, ¶ 736, at 301 ("[Amendments enacted in 1981] were primarily aimed at removing the priority for personal tax debts," but "priorities which relate to employers and other persons being required to collect tax and remit it to the Commissioner have largely been left untouched."); *Insolvency (Tax Priorities) Legislation Amendment Act, 1993* (abolished remaining priority for withholding type taxes, municipal and local rates, and land tax); *New Zealand* - STUDY PAPER, *supra* note 6, ¶¶ 90-91, at 28 (noting that absolute Crown priority remained in force for companies until 1993); *Canada* - Jacob S. Ziegel, *Canada's Phased-In Bankruptcy Law Reform*, 70 AM. BANKR. L.J. 383, 409 (1996) (noting that a 1992 law "eliminates preferential status for all Crown claims . . . [and] denies secured creditor status for all Crown claims . . . unless the lien was registered in a provincial register

1999, the New Zealand Law Commission issued a Study Paper recommending yet further limitations on priority for tax claims in insolvency proceedings.²⁵

[470] III. CURRENT TREATMENT OF TAX CLAIMS IN INSOLVENCY PROCEEDINGS

A. OVERVIEW OF INSOLVENCY LAWS

As described more fully below, each of the eight countries examined in this Article has laws that govern both the liquidation of business entities and the bankruptcy of individuals.²⁶ Each country also has laws that provide for some type of rehabilitation or reorganization for entities engaged in business, although the nature and goals of the proceeding and the specific relief available vary considerably from country to country.²⁷

governing security interests in personal property."); *United States* - BANKRUPTCY COMMISSION REPORT, *supra* note 11, at 216 (noting that 1966 legislation reduced priority for tax claims to three years), *but see* 11 U.S.C. §§ 507, 545 (1994) (showing that Congress rejected Bankruptcy Commission's recommendation that tax priorities generally be limited to one year and that statutory tax liens be limited.); *Germany* - Christoph G. Paulus, *The New German Insolvency Code*, 33 TEX. INT'L L.J. 141, 144 (1998) (new German insolvency code, effective January 1, 1999 includes "the general abolition of privileges (including the notorious fiscus privilege)"); *France* - David, *supra* note 6, at 221 (Because taxes and social security debt very generally exhaust assets of business and destroy hope of other creditors receiving payment, "rights of preferential creditors were therefore reduced by the 1985 law.").

²⁵STUDY PAPER (N.Z.), *supra* note 6, ¶¶ 246-49, at 62 (recommending that "specific priorities for PAYE [payroll withholding] deductions . . . be repealed . . . on the grounds that they are amounts deducted by the company from wages or salary of an employee in order to satisfy obligations of the employee . . . and that the PAYE portion of the wages claim be in addition to the [limit on priority for unpaid wages]," that "preferential entitlements for GST, customs duty [and certain levies] be abolished," and that "preferential status of NRWT [Non-Resident Withholding Tax] and RWT [Resident Withholding Tax] deductions should continue") and ¶ 218, at 56 ("offering the suggestion that only perfected security interests under the proposed Personal Property Securities Act and registered mortgages over land should be considered as secured creditors for insolvency purposes"). In the United Kingdom, the Chancellor of the Exchequer and the Secretary of State for Trade and Industry set up a Review of Company Rescue and Business Reconstruction Mechanisms in September 1999. One of the three principal areas of focus for the review is a "re-assessment of the relative rights and remedies of secured and unsecured creditors in insolvencies to include the Crown as a preferential creditor"; A REVIEW OF COMPANY RESCUE AND BUSINESS RECONSTRUCTION MECHANISM § 1(b), *available at* <<http://www.insolvency.co.uk/legal/corescue.htm>> (last visited Dec. 16, 2000) [hereinafter UK REVIEW]. As of Apr. 12, 2000, the report on this area had not been issued (personal communication with Philip Coates).

²⁶*England* - Insolvency Act, 1986, c. 45, Parts IV-VII (company winding up), Parts IX-XI (individual bankruptcy); *Australia* - Corporations Law, 1993, pt. 5.4 (company winding up); Bankruptcy Act, 1966 (individual bankruptcy); *New Zealand* - Companies Act, 1993 (company winding up); Insolvency Act, 1967 (individual bankruptcy); *Canada* - Bankruptcy and Insolvency Act, R.S.C., ch. B-3 (1985); *United States* - 11 U.S.C. §§ 701-766 (1994); *Germany* - *Insolvenzordnung*, v. 5.10.1994 (BGBl. I S.2866); *France* - Law No. 85-89 of January 25, 1985, effective January 1, 1986, subject to Decree Nos. 85-1388 and 85-1389 of December 27, 1985; *Mexico* - *Ley de Concursos Mercantiles*, D.O. (May 12, 2000).

²⁷*England* - Insolvency Act, 1986, c. 45, Parts I-II (company voluntary arrangements and administration), Part VIII (individual voluntary arrangements); *Australia* - Corporations Law, 1993, pt. 5.1 (schemes of arrangement), pt. 5.3 (administration and deed of company arrangement); *New Zealand* - Corporations (Investigation and Management Act), 1989, (government receivership); *Canada* - Bankruptcy and Insolvency Act, R.S.C., ch. B-3 (1985); Company Creditors' Arrangement Act, R.S.C., ch. C-36 (1985); *United States* - 11 U.S.C. §§ 1101-1174 (1994); *Germany* - *Insolvenzordnung*, v. 5.10.1994 (BGBl. I S.2866); *France* - Law No. 85-89 of January 25, 1985,

1. Liquidation

Liquidation procedures provide "a collective proceeding that seeks to achieve equitable treatment among creditors and to maximize the assets distributed to creditors."²⁸ As such, they address intercreditor problems that arise where a troubled business has insufficient assets to pay all of its creditors in full. Ultimately, liquidation laws benefit all participants in the economy by imposing discipline on debtor-creditor relationships in a way that supports the granting of credit and development of financial markets.²⁹ It is the only means of "ultimate exit" for an insolvent debtor.³⁰

The general scheme for liquidation is similar in the eight countries reviewed. When the decision is made to liquidate an insolvent business, an unrelated person is appointed to sell the debtor's assets and distribute the [471] proceeds to creditors in a collective proceeding.³¹ The laws generally entitle the holders of liens or security interests to priority as to their collateral. Many of the laws, but not all, contain rules that entitle certain categories of unsecured creditors to priority treatment for their claims over general unsecured creditors. Costs of administering the proceeding generally are paid first. Tax claims and employee claims are the unsecured claims most often afforded some type of priority over payments to general unsecured creditors.

All of the laws governing liquidation stay collection efforts by general unsecured creditors once a proceeding has been initiated; and all of the laws distribute proceeds to such creditors on a pro rata basis after secured and priority creditors are paid. Many of the laws enable an individual debtor to obtain a discharge of debts as a result of going through the liquidation proceeding; however, some of these laws except from the discharge particular categories of debts, such as debts arising from egregious conduct.

2. Rehabilitation

In contrast to liquidation, rehabilitation procedures "give an enterprise some breathing space to recover from its temporary liquidity difficulties or more permanent overindebtedness and,

effective January 1, 1986, subject to Decree Nos. 85-1388 and 85-1389 of December 27, 1985; *Mexico - Ley de Concursos Mercantiles*, D.O. (May 12, 2000).

²⁸IMF REPORT, *supra* note 1, at 13.

²⁹*Id.* A troubled business normally is liquidated only when rehabilitation is not possible. Nevertheless, liquidation procedures "are generally viewed as the 'core' proceedings upon which rehabilitation procedures are structured," because companies that reorganize normally do so by relying on the "shadow" of liquidation. *Id.* at 18.

³⁰THE WORLD BANK, BUILDING EFFECTIVE INSOLVENCY SYSTEMS: REHABILITATION § 4.1, available at <http://www1.worldbank.org/legal/insolvency_ini/wg6-paper1.htm> (last visited November 29, 2000) [hereinafter BUILDING EFFECTIVE INSOLVENCY SYSTEMS].

³¹Creditors secured by debentures or floating liens in common law countries may use a receivership to liquidate their collateral. *See, e.g., England - Insolvency Act, 1986, c. 45, Part III (Eng.); New Zealand - Receiverships Act, 1993 (N.Z.)*. While the result of a receivership may be the sale of the assets of a business as a going concern, it is a secured creditors' remedy and not a collective proceeding for the benefit of all creditors.

where necessary, provide it with an opportunity to restructure its operations and its relations with creditors.³² The procedures may provide a way to bind creditors who are unwilling to agree to a restructuring of their claims and encourage a debtor to restructure its business before its problems become too severe.³³ Rehabilitation procedures may also preserve the going concern value of the business by encouraging owner/managers to remain with the company and may indirectly serve other social and political ends, such as the protection of employment.³⁴

B. OVERVIEW OF TAX LAWS

A detailed treatment of the tax laws and administrative enforcement remedies of the eight countries discussed here is beyond the scope of this Article. [472] However, in order to understand the rules that apply in insolvency cases, some basic points of reference are necessary.

1. *Types of Taxes*

Each country examined in this Article imposes both "direct" and "indirect" taxes. Although the labels can be confusing, direct taxes are generally taxes that are payable by and collectible from the taxpayer itself. Examples include taxes on individual and corporate income, gross receipts, profits, capital gains, and assets. Direct taxes can also be viewed as including payroll taxes and compulsory social security and pension contributions for which an employer is liable as well as property taxes, such as real estate taxes.

Indirect taxes are taxes for which the debtor is the tax collector rather than the taxpayer.³⁵ These taxes include taxes that are (1) owed by employees, (2) withheld from employee wages or salaries, and (3) paid by the employer to the taxing authorities--such as income taxes, unemployment insurance taxes, or social security/pension taxes. These taxes, sometimes known as "pay as you earn" (PAYE) taxes, have a quasi-trust nature.

A similar group of income taxes may be withheld from the interest or dividends earned by taxpayers who are either residents or nonresidents of the jurisdiction in which the withholding institution is located. These taxes include foreign withholding taxes and are sometimes referred to as "resident withholding taxes" (RWT) or "nonresident withholding taxes" (NRWT).

³²IMF REPORT, *supra* note 1, at 13. Rehabilitation procedures are known by a variety of terms, including "rescue," "reorganization," "arrangement," "restructuring," and "administration." BUILDING EFFECTIVE INSOLVENCY SYSTEMS, *supra* note 30, § 4.3. While these procedures may have different goals in terms of saving the business as opposed to preserving the existing entity, "what the different cultures have in common is that a formal process is established which is capable of providing the opportunity for rationalising the business and financial affairs of a corporation." *Id.*

³³*Id.*

³⁴*Id.*

³⁵For a description of the withholding tax systems of the countries that are the subject of this paper other than Mexico, see ORGANIZATION FOR ECONOMIC COOPERATION AND DEVELOPMENT, TAXPAYERS' RIGHTS AND OBLIGATIONS: A SURVEY OF THE LEGAL SITUATION IN OECD COUNTRIES 15 and Table 4, at 30-32 (1990). Mexico is not included in the survey because it did not become a member of the OECD until 1994.

A third group of indirect taxes includes sales taxes and value added taxes (VAT), sometimes referred to as goods and services taxes (GST). Sales taxes generally are payable by the seller of goods or services, but are added to the price of the goods and services provided to the buyer. VAT are general taxes on consumption that are added to the price of goods and services in the production and distribution process.³⁶

Finally, customs duties and excise taxes--taxes on the sale of specifically listed goods, such as gasoline, alcohol, and tobacco--have an indirect impact in the sense that the cost is often passed through to the ultimate purchaser.³⁷

There may be multiple layers of taxes in situations where taxes are imposed on both a national and local level. In some countries, both a national and local government impose the same types of taxes. For example, in the United States and Canada, both the federal government and most individual [473] states/provinces impose income taxes. Other taxes may be imposed by only one level of government, such as sales tax and real estate tax. In some countries, such as Germany, taxation is a federal matter; but the revenues are shared with the states and local authorities.³⁸

Obviously, a country's revenues may depend more heavily on one group of taxes than another.³⁹

2. Tax Administration and Enforcement

Each country studied in this Article has administrative procedures for assessing and collecting taxes.⁴⁰ When taxes are overdue, interest and penalties are generally imposed.⁴¹ In addition, when taxes become delinquent, each country has measures for seizing taxpayers' property, although this is generally done only as a last resort after several notices have been given.⁴² Other collection powers are available as well, the most common being a type of garnishment through which taxing authorities may claim either money owed to the taxpayer by a

³⁶David Williams, *Value-Added Tax*, in 1 TAX LAW DESIGN AND DRAFTING 164, 169-70 (Victor Thuronyi ed., 1996).

³⁷Ben J.M. Terra, *Excises*, in 1 TAX LAW DESIGN AND DRAFTING 246, *supra* note 36, at 247, 260-61.

³⁸Willi Leibfritz et al., *The Tax System of Germany*, 10 TAX NOTES INT'L 465, 476 (1995) (discussing assignment of yield of certain taxes to local governments).

³⁹For a description of the revenues obtained from certain categories of taxes in the eight countries examined in this paper, see ORGANIZATION FOR ECONOMIC COOPERATION AND DEVELOPMENT, REVENUE STATISTICS 1965-1998, Chart 5, at 215 (structure of central government tax receipts for 1997), Chart 6, at 216 (structure of state and local government tax receipts for 1997), and Table 7, at 71 (tax revenue from main categories as percentage of total taxation) (1999 ed.).

⁴⁰ORGANIZATION FOR ECONOMIC COOPERATION AND DEVELOPMENT, *supra* note 35, at 15-19 and accompanying Tables.

⁴¹*See id.* at 18 and Table 13 at 62-66.

⁴²*See id.* at 18 and Table 10, Column 1, at 55-56. Contrast New Zealand, where property can only be seized through court orders against employers who fail to pay the PAYE tax. *Id.*

third party or property of the taxpayer held by a third party, simply by sending out a notice.⁴³ Additional enforcement powers include forcing the taxpayer into bankruptcy, with priority given to the tax claims,⁴⁴ and in the United States, simply recording a notice of lien against the taxpayer's property in real and personal property records.⁴⁵

In many countries, the key persons within a company responsible for collecting and paying over taxes withheld from employee wages can be held personally liable, along with the company, for unremitted withholding obligations. The standard of culpability for imposing such liability varies.

Additional remedies may be available for specific types of taxes. For example, customs authorities may be able to assert a possessory lien on imported goods for unpaid customs duties, and unpaid property taxes may become a lien on the property that is subject to the tax.

The tax authorities in some countries have powers to negotiate a settlement [474] with the taxpayer to take account of personal hardship.⁴⁶

C. OVERVIEW OF TREATMENT OF TAX CLAIMS IN INSOLVENCY PROCEEDINGS

The priorities or preferences granted for tax claims are most often found in special priority provisions and exceptions to the debtor's discharge in a country's insolvency legislation. The extent to which tax claims are granted priority varies widely among the eight countries examined, with the variation often depending on the type of tax in question and the period during which the tax came due.

Even where the country's insolvency law does not grant priority to tax claims, preferential treatment may arise as a result of the laws and procedures governing tax collection. For example, if taxing authorities obtain a lien for delinquent taxes, the tax claims may be treated as secured claims in the insolvency proceeding. Similarly, special levy or garnishment rights that are not stayed by the commencement of an insolvency proceeding effectively grant the taxing authorities a priority. Finally, measures such as the imposition of statutory interest and penalties, and the imposition of personal liability on nondebtor third parties for the debtor's taxes, afford collection advantages to taxing authorities that general unsecured creditors do not enjoy.

⁴³See *id.* at 18 and Table 10, Column 2, at 55-56.

⁴⁴*Id.*

⁴⁵26 U.S.C. § 6321 (2000). See *infra* notes 178-82 and accompanying text.

⁴⁶ORGANIZATION FOR ECONOMIC COOPERATION AND DEVELOPMENT, *supra* note 35, at 17-18 and Table 11 at 57-59.

D. CURRENT INSOLVENCY LAWS AND TREATMENT OF TAX CLAIMS

1. *England*

a. Insolvency Laws in England

Under the Insolvency Act 1986 (the "IA"),⁴⁷ an insolvent company can be "wound up" (liquidated) either through a judicial proceeding or out of court.⁴⁸ In either case, an insolvency practitioner is appointed to act as liquidator.⁴⁹ In a judicial winding up, the entry of the winding up order stays unsecured creditors from pursuing actions against the debtor and its property.⁵⁰ However, the rights of secured creditors are not automatically stayed--a secured creditor can continue to enforce its rights in collateral.

[475] Individual bankruptcy cases are always commenced by a judicial proceeding.⁵¹ Individual debtors generally are entitled to receive a discharge of debts after three years, subject to exceptions for claims based on fraud, certain crimes, and fines.⁵²

The primary relief for a secured creditor holding a floating lien⁵³ is the nonjudicial remedy of administrative receivership. In an administrative receivership the secured creditor appoints an administrative receiver to collect its debt from collateral proceeds.⁵⁴ Often, the administrative receiver sells the business as a going concern. Because the administrative receivership is a secured creditor's remedy, there is no provision for protection of unsecured creditors, who must seek a winding up order for the company in order to protect their rights.

⁴⁷Insolvency Act, 1986, c. 45 (Eng.) [hereinafter IA]. The IA consolidated the English insolvency laws into a single statute. It distinguishes between corporate and individual insolvency proceedings, and includes certain provisions that apply to both types of proceedings.

⁴⁸There are two types of liquidations available for insolvent companies. The creditors voluntary liquidation is an out of court liquidation commenced by the directors. IA, Part IV, Chapter IV. A compulsory liquidation is an involuntary judicial liquidation commenced by a creditor or the Department of Trade and Industry. *Id.*

⁴⁹The insolvency practitioner may be either an accountant or a lawyer authorized by the Department of Trade and Industry to serve as liquidator. FLETCHER, *supra* note 22, at 24-30.

⁵⁰IA §§ 130 (company), 285 (individual).

⁵¹FLETCHER, *supra* note 22, Chapter 6.

⁵²IA §§ 279 (discharge after three years, except for summary cases where available after two years), 281 (certain debts not dischargeable, and certain debts only discharged if the court sees fit to discharge them).

⁵³A "floating lien" or "floating charge" is a "flexible form of security allowing assets which would normally turn over in a business to be charged so that the business can continue to trade normally without restriction. It usually applies to assets which are changing or turning over in the course of a company's business, such as stock and trade debtors. . . . The charge covers both present and future assets which will change during the life of the business." In contrast, "[a] fixed charge is a charge which relates to specific assets described in the debenture agreement . . . [and] usually attaches to assets retained by the company permanently for the purpose of carrying out its business." ADAM TOWNLEY & DAVID PRATT, A PRACTICAL GUIDE TO INSOLVENCY, ¶¶ 7.4.5-7.4.7, at 196-97 (1995).

⁵⁴IA, Part III.

The focus of English law has been to save the business and jobs, rather than the corporation itself. Most business rescues in England involve the sale of assets of the business as a going concern, with the debtor corporation itself liquidating.⁵⁵

The main vehicle for reorganization of a troubled company is a corporate voluntary arrangement ("CVA").⁵⁶ The CVA is a simplified form of restructuring, which can be put in place with little court involvement, as long as creditors agree to it by the requisite majority.⁵⁷ No stay is available through the CVA procedure itself,⁵⁸ and secured creditors' interests cannot be affected [476] without their consent.⁵⁹ Because the CVA does not bind dissenting creditors and can be challenged within a short time on the grounds of unfair prejudice,⁶⁰ the procedure is best suited for simpler cases where there are relatively small numbers of creditors with generally similar interests.

In order to obtain the benefits of a stay of creditor action, a company must apply to the court for an administration order.⁶¹ The entry of an administration order creates a mandatory stay of creditor actions, including secured creditor actions, subject to exceptions agreed upon by the administrator or imposed by the court.⁶² An administrator is appointed to act as the agent of the corporation with the powers of a receiver appointed to deal with floating security.⁶³ The administrator reports to the creditors on the status of the company's prospects; thereafter, the creditors determine whether the administration should be dismissed, and if so, whether the company should be liquidated, or placed into a CVA.⁶⁴ Use of an administration order is limited

⁵⁵Gabriel Moss, *Comparative Bankruptcy Cultures: Rescue or Liquidation? Comparison of Trends in National Law--England*, 23 BROOK. J. INT'L L. 115, 121-22 (1997) ("In England, judges tend to favour the financiers; bankers appear to have acquired respectability over the centuries whereas those who take risks in business have not. English judges also tend to be sympathetic towards insolvency practitioners as opposed to debtors; the licensed insolvency practitioners tend to be professionals known to the court, whereas the debtor's descent into insolvency tends to be treated as grounds for suspicion.").

⁵⁶IA, Part I. Individual Voluntary Arrangements are also available. IA, Part VIII.

⁵⁷IA §§ 3-5.

⁵⁸The CVA procedure has been criticized for this reason. FLETCHER, *supra* note 22, at 415 ("Among analysts and commentators, a widespread consensus has emerged that the single most important reason for the near-negligible usage of the CVA is the lack of a statutory moratorium (sometimes referred to as an 'automatic stay') to prevent creditors from enforcing remedies, including enforcement of security, during the period when active efforts are in progress to conclude an arrangement."); UK REVIEW, *supra* note 25, § 6(c) ("the current absence of a stay on creditors' actions means that any creditor can pursue individual remedies and thereby frustrate collective agreement").

⁵⁹IA § 4(3).

⁶⁰IA § 6(1)(a).

⁶¹IA § 8.

⁶²IA §§ 10-11.

⁶³IA § 14.

⁶⁴Another procedure for corporate reorganization is the scheme of arrangement, which is complex and little used, but in principle can be used whether or not the company is insolvent. Lacey, *supra* note 6, at 46. Drawbacks of the scheme of arrangement procedure are the absence of a stay, expense, and lack of statutory powers to investigate and attack transactions. *Id.* at 57 n.18.

by the ability of a holder of a floating lien to appoint an administrative receiver, thereby stopping the administration.⁶⁵

b. Treatment of Tax Claims in England

Government claims have no preferential status in company winding up or individual bankruptcy except as provided in the insolvency legislation.⁶⁶ Under Section 386 and Schedule 6 to the IA, the following are preferential debts entitled to priority treatment in both company winding up proceedings⁶⁷ and in individual bankruptcies:⁶⁸ (1) income tax withheld from emoluments (twelve months)⁶⁹ and from amounts due to subcontractors in the [477] construction industry (twelve months);⁷⁰ (2) value added tax and insurance premium tax (six months),⁷¹ vehicle tax (twelve months),⁷² and tax on various activities and gaming licenses (six or twelve months);⁷³ (3) social security contributions (twelve months);⁷⁴ (4) contributions to occupational pension schemes and state scheme premiums;⁷⁵ and (5) sums due in respect of certain European Community levies on the production of coal and steel and surcharges for delay in payments.⁷⁶

Section 386 incorporates some of the recommendations of the 1982 Cork Report, such as the elimination of preference for taxes assessed directly against the company as taxpayer, including corporate income taxes and capital gains tax, and the elimination of the preference for local rates.⁷⁷ It also reduces the priority period for value added tax payments from one year to six months.⁷⁸

⁶⁵IA § 9(3).

⁶⁶FLETCHER, *supra* note 22, at 293 ("By virtue of section 434(b) of the Insolvency Act 1986, the Crown is bound by the provisions of the Act relating to priorities of debts, so that all other debts owed by the debtor to the Crown, with the exception of those specific categories of debts mentioned in Schedule 6, will rank along with the ordinary debts owed to the general body of creditors.").

⁶⁷IA § 175(1).

⁶⁸IA § 328(1).

⁶⁹*Id.* § 386, sched. 6, ¶ 1 (These are deductions "which the debtor was liable to make under section 203 of the Income and Corporation Taxes Act 1988, Section 203 (pay as you earn), less the amount of the repayments of income tax which the debtor was liable to make during that period.").

⁷⁰*Id.* ¶ 2 (These are sums due "in respect of such deductions as are required to be made by the debtor under section 559 of the Income and Corporation Taxes Act 1988 (subcontractors in the construction industry).").

⁷¹*Id.* ¶¶ 3, 3A.

⁷²*Id.* ¶ 4.

⁷³*Id.* ¶¶ 5A-5C (Taxes include general betting duty, bingo duty, general betting duty and pool betting duty recoverable from an agent collecting stakes, gaming licence duty, beer duty, lottery duty, and air passenger duty).

⁷⁴*Id.* ¶¶ 6-7 (Relevant legislation is Class 1, 2, and 4 Contributions under the Social Security Act 1975 and Social Security (Northern Ireland) Act 1975 (but note specific rules in relation to Class 4 Contributions). These are deductions the employer is required to make from employees' emoluments for compulsory contributions by employees to a state social security fund for pensions and other benefits.).

⁷⁵*Id.* ¶ 8 (These are sums owed under the Pensions Schemes Act 1993).

⁷⁶*Id.* ¶ 15A (These are sums due in respect of Articles 49, 50, and 50(3) of the ECSC Treaty, Article 6 of Decision 3/52 of the High Authority of the Coal and Steel Community).

⁷⁷FLETCHER, *supra* note 22, at 293 (In 1985, "reforms were implemented to abolish the Crown's privileged position as a preferential creditor for unpaid taxes assessed directly upon the insolvent debtor (individual or

In a liquidation, these priority tax claims are paid *pari passu* with priority wage claims, after the costs of administration. Moreover, because of their monopolistic scope, floating liens are subordinated to these priority claims.⁷⁹ Claims secured by fixed liens and mortgages, however, can be enforced independently [478] of a winding-up.⁸⁰

In an administrative receivership, priority claims must be paid out of any proceeds realized from property subject to a floating lien before payment to the lienholder. If the receiver pays assets or dissipates them without providing for the payment of priority creditors, the receiver will be personally liable to make up the resulting shortfall to those creditors.

Creditors who would be otherwise paid preferentially in a liquidation may not be prejudiced under a CVA unless they agree. In practice, a priority creditor generally agrees to modified treatment of its claim if alternative procedures such as liquidation would yield a lower return.⁸¹

2. Australia

a. Insolvency Laws in Australia

In Australia, the Corporations Law governs corporate "winding up in insolvency."⁸² As in England, corporate liquidations are conducted by a liquidator⁸³ and can be judicial or nonjudicial.⁸⁴ In a court liquidation, an automatic stay is imposed so that no action, can be commenced by unsecured creditors while the company is being wound up, except with the leave

corporate) as taxpayer to the Inland Revenue, and also to abolish the preferential status formerly accorded to local rates.").

⁷⁸*Id.* ("A further change in the law had the effect of restricting Crown preference in respect of outstanding payments of Value Added Tax to a period of six months, as against the period of twelve months which is applicable for other debts due to Customs and Excise."). *See also*, CORK REPORT (Eng.), *supra* note 6, ¶ 1423, at 323 ("We have reached the conclusion that the present twelve month period for preference is excessive, and propose that it be shortened. We consider that in the future the period for preference for each tax should be related to the intervals in between returns.").

⁷⁹IA § 175(2)(b); WOOD, *supra* note 3, at 24-25 ("In England and English-based countries, the preferential creditors (basically taxes and wages) rank ahead of floating charges, by reason of the monopolistic scope of the floating charge."); FLETCHER, *supra* note 22, at 610 ("Any charge which, as created, was a floating charge is permanently relegated behind the preferential creditors' claims in order of ranking against the assets in question, irrespective of whether the terms of the charge-creating instrument purport to cause it to crystallise into a fixed charge before the date of commencement of the liquidation.").

⁸⁰FLETCHER, *supra* note 22, at 610.

⁸¹Lacey, *supra* note 6, at 46. *But see*, UK REVIEW, *supra* note 25, § 6(i) (noting that "in a recent case the European Court of Justice has found the grant of an extended time to pay [VAT and PAYE] to be an anti-competitive state aid.").

⁸²Corporations Law, 1993, pt. 5.4 (Austl.) (New insolvency legislation was enacted in Australia in the Corporations Act 1989. This Act was amended several times in subsequent years. The amended Act is commonly known, and is cited in this Article, as the Corporations Law.).

⁸³*Id.* § 472.

⁸⁴*Id.* pts. 5.4 (Winding up in Insolvency), 5.5 (Voluntary Winding Up).

of the court and on such terms as the court imposes.⁸⁵ The winding up does not affect the rights of secured creditors to realize on or deal with their security.⁸⁶

The main vehicle for reorganization is voluntary administration, which came into force in 1993.⁸⁷ An administrator is appointed to administer the property and affairs of an insolvent company in a way that "maximises the chances of the company, or as much as possible of its business, continuing in existence."⁸⁸ If it is not possible for the business to continue, the administrator is to recommend that the business be liquidated in a way that results in a "better return for the company's creditors and members than would result [479] from an immediate winding up of the company."⁸⁹ The voluntary administration procedure has been described as "highly purposeful toward saving business and maximising returns for creditors, but also providing the opportunity in an appropriate case for the restructure and reorganization of the debtor company itself."⁹⁰

There is very little court involvement in the voluntary administration process.⁹¹ The appointment of an administrator stays creditor action against the company and its property.⁹² This stay, however, does not extend to secured creditors who have a "floating charge" over substantially all of the company's assets; such creditors may elect within a specific period of time to seek enforcement of their security independent of the proceeding.⁹³ The administrator investigates the company's options and the creditors decide whether the company should be wound up, whether they should execute a "deed of company arrangement," or whether the administration should be dismissed.⁹⁴

The deed of company arrangement is an agreement between the company and its creditors which determines the future terms for the company to deal with its creditors. It generally involves extensions of the required payment periods and compromise as to outstanding debts.⁹⁵ The deed binds unsecured creditors and secured creditors who vote for the arrangement or whose

⁸⁵*Id.* § 471B. Individual bankruptcy is governed by the Bankruptcy Act, No. 33 of 1966 (Austl.).

⁸⁶Corporations Law, 1993, § 471C (Austl.).

⁸⁷*Id.* pt. 5.3 (Austl.) (Administration of a Company's Affairs with a View to Executing a Deed of Company Arrangement). "Schemes of arrangement" under Part 5.1 of the Corporations Law may be used by a larger company where the administration procedures take too long. The scheme must be approved by the statutory majority of creditors. Where a scheme has been proposed but not voted on, the court can restrain proceedings against the company. Section 411(16).

⁸⁸*Id.* § 435A.

⁸⁹*Id.*

⁹⁰Ron W. Harmer, *Comparison of Trends in National Law: The Pacific Rim*, 23 BROOK. J. INT'L L. 139, 150 (1997).

⁹¹*Id.* at 152 ("The courts are not involved in the initiation nor the ongoing processing of the procedure, but they may exercise, if required, both a facilitating and supervisory jurisdiction. . . . The decision making is left largely to the principal participants - the company and its creditors" (footnote omitted)).

⁹²*See* Corporations Law, *supra* note 82, §§ 440-41.

⁹³Harmer, *supra* note 90, at 155.

⁹⁴*See* Corporations Law, *supra* note 82, § 435C.

⁹⁵*Id.* § 439.

rights are limited by court orders.⁹⁶ Normally the deed provides that claims of creditors bound by the deed are discharged immediately or upon payment of their obligations, but in some cases the deed might only provide for a moratorium and not a discharge.

b. Treatment of Tax Claims in Australia

The Corporations Law provides that all debts in a winding up rank equally, unless otherwise provided by the Corporations Law.⁹⁷ Secured creditors (under a mortgage, floating charge, or statutory lien) are entitled to priority with regard to the assets to which their security attaches. Employees are entitled to priority distributions.⁹⁸

[480] Australia has abolished all statutory tax priorities. In 1978, the Senate Standing Committee on Constitutional and Legal Affairs recommended abolition of all Crown priority.⁹⁹ In 1981, Parliament took the first step and removed the priority for direct personal tax debts.¹⁰⁰ However, the 1981 law retained priorities that related to employers and other persons required to collect and remit taxes,¹⁰¹ such as the (1) unremitted group tax (income tax deducted from salaries or wages of employees),¹⁰² (2) unremitted prescribed payments deductions,¹⁰³ (3) unremitted natural resource or royalty payment deductions,¹⁰⁴ and (4) unpaid withholding tax.¹⁰⁵

The 1988 Harmer Report recommended abolition of priority for the foregoing indirect taxes paid to the Commissioner of Taxation.¹⁰⁶ The report also recommended that remaining priorities for state, territory and local government taxes be abolished, noting that municipal and local rates and land tax will generally be a charge or otherwise secured over the land and on this basis no specific priority is necessary.¹⁰⁷

In 1993, in accordance with these recommendations the Commissioner's priority over other creditors for unremitted tax payable after June 30, 1993 was abolished.¹⁰⁸ The benefit of this change accrues to the holders of a floating charge if there is one over the debtor's assets.¹⁰⁹ To compensate the Commissioner for this loss of priority, company directors have been made

⁹⁶*Id.* § 444.

⁹⁷*Id.* § 555.

⁹⁸*Id.* § 561.

⁹⁹HARMER REPORT (Austl.), *supra* note 6, ¶ 736, at 301.

¹⁰⁰*Id.*

¹⁰¹*Id.*

¹⁰²¶733, at 299.

¹⁰³*Id.*

¹⁰⁴*Id.*

¹⁰⁵*Id.*

¹⁰⁶*Id.* ¶ 741, at 303.

¹⁰⁷*Id.* ¶¶ 742-743, at 303-04.

¹⁰⁸Insolvency (Tax Priorities) Legislation Amendment Act, 1993 (Austl.); TOWNLEY & PRATT, *supra* note 53, P2.17.4, at 97.

¹⁰⁹TOWNLEY & PRATT, *supra* note 53, ¶ 7.10.2, at 215.

personally liable for unremitted tax; and the Commissioner is now permitted to initiate winding-up proceedings for an uncertain amount.¹¹⁰

Secured creditor status may be given by statute, however, so that land tax and local rates can be protected if they become a charge or lien on specific property.¹¹¹

[481] 3. *New Zealand*

a. Insolvency Laws in New Zealand

New Zealand has a broadly pro-creditor bankruptcy culture based on English ideas. Company liquidation is governed by the Companies Act 1993,¹¹² and individual bankruptcy is governed by the Insolvency Act 1967.¹¹³ In a company liquidation, a liquidator is appointed by the court or nominated by the company and creditors. The commencement of a proceeding stays unsecured creditors from proceeding with their claims against the debtor and its property, but does not stay secured creditors.¹¹⁴

Opportunities for the reorganization of a company under New Zealand law are limited.¹¹⁵ A receiver for a secured creditor may be appointed where a security agreement creating a floating charge or a mortgage so provides.¹¹⁶ The receiver, once appointed, may determine how the secured creditor's claim should be paid, either through piecemeal liquidation or sale of the assets as a going concern. A receiver appointed under a floating charge must ensure that priority creditors are paid before the lienholder.¹¹⁷

The only other procedure available to avoid a liquidation is "statutory management." Statutory management is a government imposed receivership designed to protect all stakeholders, rather than just secured creditors, against corporate misfeasance in the event of

¹¹⁰*Id.* ¶ 2.17.4, at 97.

¹¹¹*Id.* ¶ 2.17.2, at 96 ("Security . . . may also be given by statute, for example s 28 of the Income Tax Assessment Act 1936 (Cth)."); HARMER REPORT (Austl.), *supra* note 6, ¶ 742, at 303-04 (recommending abolition of priority for state and territory taxes, noting that "municipal and local rates and land tax will generally be a charge or otherwise secured over the land and on this basis the specific priority is unnecessary.").

¹¹²Companies Act, 1993 (N.Z.).

¹¹³Insolvency Act, 1967 (N.Z.).

¹¹⁴SUSAN WATSON ET AL., THE LAW OF BUSINESS ORGANISATIONS, ¶ 18.08.22, at 386 (1995) ("The liquidation of a company does not prevent a secured creditor from realising its security and repaying itself from the sale proceeds. To this extent, a secured creditor stands outside the liquidation.").

¹¹⁵Administration law reform proposals to assist in rescuing ailing companies like those found in the UK and Australian laws, were not part of the 1993 law reform. *Id.* ¶ 17.13, at 370-72.

¹¹⁶Receiverships Act, 1993 (N.Z.); WATSON, *supra* note 114, ¶ 17.02.2, at 349-50 ("With few exceptions, receiverships in New Zealand are initiated by a secured creditor pursuant to the provisions of a security agreement (such as a floating charge or mortgage) entered into with the debtor company.").

¹¹⁷Receiverships Act, 1993 § 30 (N.Z.). Preferential creditors are those entitled to priority under the Seventh Schedule to the Companies Act, 1993 (N.Z.). See *infra* notes 122-25 and accompanying text.

major corporate collapse.¹¹⁸ The stay in a statutory management is very broad and extends to secured creditors. Creditors have virtually no influence on the proceedings and the government appointed manager has very wide powers, including the ability to sell assets subject to a floating charge without repaying the floating chargeholder, a feature that has subjected the law to criticism.¹¹⁹ The procedure [482] is used sparingly and only where ordinary remedies are insufficient to protect interested persons or the public from a company that is operating fraudulently or recklessly.¹²⁰

b. Treatment of Tax Claims in New Zealand

Statutory priorities for payment of creditors in a company liquidation are found in Section 312 and the Seventh Schedule to the Companies Act 1993. Generally, the following tax claims are entitled to priority: (1) unpaid goods and services tax;¹²¹ (2) deductions under pay-as-you-earn rules, nonresident company withholding tax, and resident withholding tax;¹²² (3) debts under the Radiocommunications Act 1989;¹²³ (4) levies by the Ministry of Agriculture and Fisheries under the Fisheries Act 1983;¹²⁴ and (5) duties under the Customs and Excise Act 1966.¹²⁵ Similar priorities are available in personal bankruptcy cases under Section 104 of the Insolvency Act 1967, except that currently there is no priority for NRWT and RWT in individual bankruptcy cases.¹²⁶ There is no priority for individual or corporate income taxes or capital gains tax.¹²⁷

These priority debts are paid after payment of administration claims and employee claims.¹²⁸ They are paid in preference to claims secured by a floating lien but after claims secured by fixed liens and mortgages.¹²⁹ The Seventh Schedule priorities apply in receiverships as well as in liquidations.¹³⁰

¹¹⁸Corporations (Investigation and Management Act), 1989, pt. III (N.Z.). Statutory management was made available as a result of the 1987 stock market crash and subsequent significant corporate failures. WATSON, *supra* note 114, ¶ 17.12.1, at 368.

¹¹⁹WATSON, *supra* note 114, ¶ 17.12.3, at 370 ("The most controversial aspects of the legislation are the moratorium provisions and the extraordinary powers given to the statutory manager. . . . Concerns have even been expressed that this legislation could impact adversely on New Zealand's ability to attract offshore capital.").

¹²⁰*Id.* ¶ 17.12.2, at 370 ("The statutory management provisions of the Act have only been applied in the case of corporate collapses where the affairs of the companies involved were so complex and the interests of [the] stakeholders so varied that it was considered ordinary insolvency or enforcement proceedings would not produce the optimal outcome.").

¹²¹Goods and Services Tax Act, 1985, pt. III (N.Z.).

¹²²Income Tax Act, 1994, pts. IX, IXA, and XI (N.Z.).

¹²³Radiocommunications Act, 1989, § 183(4) (N.Z.).

¹²⁴Fisheries Act, 1983, § 107K(3) (N.Z.).

¹²⁵Customs and Excise Act, 1966, pt. IVA (N.Z.).

¹²⁶*See* STUDY PAPER (N.Z.), *supra* note 6, ¶ 4, at 2 (listing debts that have priority over unsecured creditors in individual bankruptcy).

¹²⁷*Id.* ¶ 94, at 29 (stating that "income tax generally is afforded no priority").

¹²⁸Companies Act, 1993, § 312 (N.Z.).

¹²⁹*Id.* § 312(2).

¹³⁰Receiverships Act, 1993, § 30 (N.Z.).

In October 1999, the New Zealand Law Commission issued an Advisory Report to the Ministry of Commerce on Priority Debts in the Distribution of Insolvent Estates (the "Study Paper"). In the Study Paper, the Law Commission recommended that some of the existing priorities be abolished and that others be retained. The Law Commission recommended that the separate priority for PAYE deductions should be repealed. Instead, these amounts should be included in the priority allowed to employee claims so that gross wages rather than net wages for a particular period are given priority.¹³¹

[483] The Law Commission also recommended that priority for GST, customs duties, levies under the Fisheries Act, and debts under the Radiocommunications Act should be abolished.¹³² The Law Commission found no compelling reason for retaining these priorities. It rejected the argument that they should be retained because the government is an involuntary creditor, finding that the government had made a conscious choice to have the debtor act as tax collector, and noting that there are other involuntary creditors, such as tort claimants, who are not entitled to priority. The Law Commission also found that priority was not needed to protect the revenue base because the legislature has given the Tax Commissioner extensive powers to collect taxes (including the imposition of interest, penalties, levies on third parties, and liens) and that protection of the revenue base is better achieved by exercising those powers in a timely manner.¹³³ The Law Commission also noted that Customs has an additional enforcement power of taking goods into custody and holding them until the duties are paid.¹³⁴

Finally, the Law Commission recommended that the priorities for NRWT and RWT, like PAYE, should be continued in company liquidations and in fact should be extended to individual bankruptcies.¹³⁵ The Law Commission reasoned that these quasi-trust debts are analogous to deductions made from earnings on behalf of third parties, such as accident victims or child support, and that it would be unjust not to assure payment for the benefit of these third parties

¹³¹STUDY PAPER (N.Z.), *supra* note 6, ¶ 112, at 34 (noting that "under the PAYE rules, the Commissioner retains the right to claim unpaid PAYE from the employees as well as the employer," and that "this may be seen as unfair to a person who has, in good faith, ordered his or her affairs on the assumption that the tax was met by the employer") and ¶¶ 246-47, at 62 (recommending "that the PAYE portion of the wage claim be in addition to the \$ 6000 limit" for employee wages).

¹³²*Id.* ¶ 248, at 62.

¹³³*Id.* ¶ 145, at 40 (recommending abolition of priority for GST because "it is not, in truth, a debt analogous to a trustee's obligation to account to a beneficiary . . . and there are no compelling reasons for requiring tax debts to be given preferential status because of . . . the need to protect the revenue base . . . or the Commissioner's (possible) position as an involuntary creditor."); ¶ 163, at 43 (recommending abolition of priority for fishing levies for foregoing reasons and rejecting the argument that priority is appropriate because levies are based on illegal activity since similar claims are not entitled to priority); and ¶ 165, at 44 (recommending abolition of priority for debts under Radiocommunications Act because there was "nothing to differentiate a levy under this Act from any general tax.").

¹³⁴*Id.* ¶ 152, at 41-42 (finding "no compelling reasons to justify priority for customs debts," and noting that "there are ample alternative remedies available to the New Zealand Customs Service to protect itself should the preference be abolished.").

¹³⁵*Id.* ¶ 249, at 62 and ¶ 146, at 40 (stating reasons for recommendation that priority for RWT and NRWT should be retained and extended to individual bankruptcies).

who order their affairs on the assumption that the payments have been made. Moreover, it would be unfair to allow the assets of the insolvent to be increased through the use of moneys the debtor ought to have paid on behalf of third parties.

[484] 4. *Canada*

a. Insolvency Laws in Canada

Prior to 1992, insolvency law in Canada was biased toward liquidation.¹³⁶ In view of the increased number of bankruptcies and recessions in the early and late 1980s, the government appointed a Bankruptcy Advisory Committee to recommend amendments to the existing legislation.¹³⁷ The Committee issued its report in 1986,¹³⁸ and the first round of amendments to the Bankruptcy and Insolvency Act ("BIA") was enacted in 1992.¹³⁹ Further amendments were enacted April 25, 1997.¹⁴⁰

The BIA applies to both companies and individuals, and includes provisions relating to both liquidation and reorganization.¹⁴¹ As in England, liquidations can be either judicial or nonjudicial.¹⁴² Judicial liquidations can be commenced either voluntarily by the debtor or involuntarily by creditors.¹⁴³ The BIA provides for an automatic stay of any action, execution, or other collection proceeding by creditors without leave of court.¹⁴⁴ A secured creditor is not automatically stayed from proceeding if it took possession of its collateral before a proposal dealing with the assets is filed.¹⁴⁵ Individual debtors are eligible for a discharge for most debts.

¹³⁶AMERICAN LAW INSTITUTE, TRANSNATIONAL INSOLVENCY PROJECT, INTERNATIONAL STATEMENT OF CANADIAN BANKRUPTCY LAW 11 (Tentative Draft 1997) [hereinafter ALI DRAFT STATEMENT (Can.)] ("Canada's bankruptcy legislation was originally based on English precepts and did not, consequently, attempt to foster reorganizations of businesses in financial difficulty. In the revised (post-1992) [Bankruptcy and Insolvency Act], Canada has moved away from a regime that was criticized as being oriented toward the liquidation of failing businesses to a regime that expressly creates new opportunities for businesses in financial difficulties to reorganize.").

¹³⁷For a description of the ongoing program of insolvency law reform in Canada, see Jacob S. Ziegel, *The Modernization of Canada's Bankruptcy Law in a Comparative Context*, 33 TEX. INT. L.J. 1, 2-3 (1998).

¹³⁸COLTER REPORT (Can.), *supra* note 14.

¹³⁹An Act to amend the Bankruptcy Act and to amend the Income Tax Act, ch. 27, 1992 S.C. 559 (Can.) (amending Bankruptcy Act, R.S.C., ch. B-3 (1985) (Can.)) (further citations to the BIA use the section numbers corresponding to the 1985 Bankruptcy Act).

¹⁴⁰An Act to amend the Bankruptcy and Insolvency Act, the Companies' Creditors Arrangement Act and the Income Tax Act, ch. 12, 1997 S.C. (Can.).

¹⁴¹ALI DRAFT STATEMENT (Can.), *supra* note 136.

¹⁴²Winding-Up Act, R.S.C., ch. W-11 (1985) (Can.) (governing nonjudicial winding up of corporations).

¹⁴³BIA §§ 43, 49.

¹⁴⁴BIA § 69.3.

¹⁴⁵BIA § 69.1(2). In addition, the receivership remedy for enforcement of a security interest in substantially all of the debtor's property and business is available in Canada. Before the remedy is enforced, the secured creditor must give the debtor ten days' notice. If the debtor initiates reorganization proceedings within the ten-day period, the secured creditor is stayed from proceeding with the receivership. If the debtor does not act within the ten-day period, the secured creditor is not bound by the stay of proceedings. BIA §§ 244, 69.1(2).

The debts excepted from discharge include penalties, fraud, and alimony, but do not include [485] tax claims.¹⁴⁶ Corporations may only receive a discharge if they pay their creditors in full or if discharge is provided under the terms of a proposal for reorganization.¹⁴⁷

Two reorganization systems have evolved in Canada, one under the BIA and the other under the Companies' Creditors Arrangement Act ("CCAA").¹⁴⁸ The BIA permits reorganization by corporations and individuals whereas the CCAA applies only to corporations. Prior to the 1992 amendments to the BIA, courts principally used the flexible but brief CCAA to reorganize troubled businesses, because the scope of the stay was within the court's discretion and was generally broader than the stay under the BIA. Now, under the amended laws, when a proposal for reorganization or a notice of intention to file a proposal is submitted in a case brought under the BIA or when an arrangement is made with creditors under the CCAA, all creditors, including secured creditors and the Crown, are stayed from enforcing their claims against the debtor and its assets.¹⁴⁹

The current view of reorganization in Canada is that "the primary focus for commercial reorganization should be on the enterprise and not on the legal framework by which the enterprise is owned or controlled."¹⁵⁰ Because the goal is to save the business and not the debtor, sale of the assets of a business as a going concern is a very acceptable result.

b. Treatment of Tax Claims in Canada

Federal and provincial Crown claimants generally rank as unsecured claimants in a bankruptcy.¹⁵¹ There are, however, several exceptions to the general unsecured ranking of tax claims owed to the Crown. First, secured interests created by law to protect the position of the Crown, if registered prior to bankruptcy pursuant to a prescribed system of registration, are treated as secured claims.¹⁵²

¹⁴⁶BIA §§ 169, 178.

¹⁴⁷BIA § 169(4). BIA § 169(4).

¹⁴⁸R.S.C., ch. C-36 (1985) (Can.), as amended by An Act to amend the Bankruptcy and Insolvency Act, the Companies' Creditors Arrangement Act and the Income Tax Act, ch. 12, 1997 S.C. (Can.) (further citations to the CCAA use the section numbers corresponding to the 1985 Companies' Creditors Arrangement Act.). For a more complete discussion of Canada's dual insolvency regime, *see* ALI DRAFT STATEMENT (Can.), *supra* note 136, at 9-12, and Ziegel, *supra*, note 137, at 9-12.

¹⁴⁹BIA §§ 69(1), 69.1, 69.2; CCAA §§ 11, 18.4, 21. The stay in a BIA reorganization remains in effect for thirty days and can be extended for up to a total of six months in forty-five day increments until a reorganization proposal is filed. Once a proposal is filed, the stay continues until the proposal is completed or the debtor is assigned into a liquidation. *But see supra* note 145 (stay is inapplicable to secured creditors who gave notice of intent to enforce security under pre-enforcement notice provisions).

¹⁵⁰ALI DRAFT STATEMENT (Can.), *supra* note 136, at 49.

¹⁵¹Moreover, the statute generally disclaims any special "trust status" for tax claims. BIA § 67(3).

¹⁵²BIA §§ 86-87. Because "registration" is a requirement, it appears that there is no priority for customs brokers who obtain security based on possession of property in their capacity as subrogees of the Crown pursuant to the Customs Act. *See* Jeffrey J. Simpson, *Crown Possessory Liens under the Bankruptcy and Insolvency Act*, 12 Comm. Insolv. Rep. 1 (October 1999).

Second, amounts withheld from employees for federal and provincial [486] equivalents for (1) income taxes, (2) unemployment insurance, and (3) employee contributions to the Canada Pension Plan are given priority status pursuant to a "deemed trust" theory.¹⁵³ These deemed trust claims are payable ahead of secured as well as unsecured claims, except for preexisting mortgages on real property.¹⁵⁴ Corporate directors can be held personally liable for payment of many of these federal and provincial withholding taxes.¹⁵⁵

The Canadian Income Tax Act gives the taxing authorities a powerful tool for collecting these unremitted source deductions. Under section 224(1.2) of the Income Tax Act, the Crown can intercept amounts owed to debtors by third parties by way of a statutory form of garnishment known as an "enhanced requirement to pay."¹⁵⁶ This administrative collection device, which requires no court action, transfers ownership of the amounts owed to the taxpayer to the taxing authorities. Because ownership is transferred as a result of the enhanced requirement to pay, the taxing authorities obtain priority over a secured creditor's claim to these amounts. Use of the enhanced requirement to pay is stayed by the filing of a proposal or notice of intention to file a proposal under the BIA and by making an arrangement with creditors under the CCAA.

Proposals for reorganization under the BIA must provide for payment in full to the Crown, with interest, of all amounts owed for the employee-related remittances described above, within six months of the court approval of the proposal.¹⁵⁷ All other taxes are treated as unsecured claims under a proposal. Both the CCAA and the BIA provide that a debtor corporation may include in its reorganization proposal a compromise of claims against the directors relating to obligations for unremitted withholding taxes for which the directors are vicariously liable.¹⁵⁸

¹⁵³An Act to amend the Income Tax Act, ch. 19, 1998 S.C. § 226 (Can.) (adding new § 227(4.1)) (effective retroactively to June 15, 1994). According to one of Canada's foremost legal scholars on bankruptcy law, monies collected under federal and provincial general sales taxes should be treated the same way. Ziegel, *supra* note 137, at 14 n.102 ("For reasons that remain unclear, the amendment does not include monies collected by the debtor under federal and provincial sales tax legislation--a conspicuous omission.").

¹⁵⁴Ziegel, *supra* note 137, at 14 n.102.

¹⁵⁵Ziegel, *supra* note 137, at 9 ("There are many federal and provincial tax statutes in Canada holding directors vicariously liable for taxes not paid by the corporation, for taxes deducted at the source, and for taxes collected on behalf of the revenue authorities but not remitted to them. Sometimes the liability is strict; at other times the directors may be exculpated if they can show that they exercised reasonable diligence to ensure that the corporation complied with its statutory obligations." (footnotes omitted)).

¹⁵⁶Income Tax Act, R.S.C., ch. 1, § 224(1.2) (1985) (Can.).

¹⁵⁷BIA § 60(1.1).

¹⁵⁸BIA § 50(13); CCAA § 5.1. *See* Ziegel, *supra* note 137, at 9.

[487] 5. *United States*

a. Insolvency Laws in the United States

The current U.S. Bankruptcy Code¹⁵⁹ was enacted in 1978. Under Chapter 7, both individuals and business entities can be liquidated either on a voluntary or involuntary basis.¹⁶⁰ Upon entry of an order for relief in a Chapter 7 case, a trustee is appointed to liquidate the debtor's assets, evaluate claims, and distribute the proceeds of the assets to creditors.¹⁶¹

Upon the filing of a liquidation case, the law provides a broad automatic stay of collection and enforcement efforts by secured and unsecured creditors.¹⁶² The stay applies both in Chapter 7 liquidations and Chapter 11 reorganizations. Secured creditors who are not adequately protected can seek affirmative relief from the court, which relief may include authorization to reclaim and liquidate their collateral outside the insolvency proceeding.¹⁶³

Individual Chapter 7 debtors are entitled to a discharge for prebankruptcy debts, with the exception of certain debts based on the nature of the claim, including fraud, willful and malicious injury, certain tax liabilities, and student loans.¹⁶⁴

Chapter 11 is the dominant proceeding for troubled businesses, which will often attempt a Chapter 11 case before converting the case to a liquidation under Chapter 7.¹⁶⁵ In contrast to other common law countries, the current management of a Chapter 11 debtor remains in control of the business as a "debtor in possession" unless there are grounds for appointment of a trustee.¹⁶⁶ The debtor in possession has the exclusive right to propose a plan of reorganization during the first four months of the case.¹⁶⁷

¹⁵⁹11 U.S.C. §§ 101-1330 (1994).

¹⁶⁰11 U.S.C. §§ 109 (individuals and entities may be debtors in Chapter 7 cases), 301 (voluntary petition by debtor), 303 (involuntary petition by creditors) (1994).

¹⁶¹11 U.S.C. §§ 701 (interim trustee), 702 (elected trustee), 704 (duties of trustee) (1994).

¹⁶²11 U.S.C. § 362(a) (1994).

¹⁶³11 U.S.C. § 362(d) (1994).

¹⁶⁴11 U.S.C. § 523(a) (1994) (nondischargeable tax liabilities include debts for taxes or customs duties that are entitled to priority under § 507(a)(8), *see infra* notes 170-76 and accompanying text; taxes for which a return was not filed or was filed late; and taxes with respect to which the debtor made a fraudulent return).

¹⁶⁵AMERICAN LAW INSTITUTE, TRANSNATIONAL INSOLVENCY PROJECT, INTERNATIONAL STATEMENT OF UNITED STATES BANKRUPTCY LAW 19 (Tentative Draft 1997) [hereinafter, ALI DRAFT STATEMENT (U.S.)]. Chapter 13 provides an alternative scheme for individuals with regular income and limited amounts of secured and unsecured debt. 11 U.S.C. §§ 1301-1330 (1994).

¹⁶⁶Grounds for appointment of a Chapter 11 trustee include fraud, dishonesty, incompetence or gross mismanagement. 11 U.S.C. § 1104(a) (1994).

¹⁶⁷11 U.S.C. § 1121 (1994). The debtor's 120-day exclusive period to file a plan is subject to extension or reduction for cause. 11 U.S.C. § 1121(d) (1994). There are separate time limits for proposing a plan in a "small business" case. 11 U.S.C. § 1121(e) (1994).

Reorganization is highly favored in the United States and is seen as a [488] method for saving jobs and preserving community values as well as a way to preserve going concern value for creditors' benefit.¹⁶⁸ Chapter 11 results in the sale of whole businesses less frequently than in other common law jurisdictions, although it often does result in realignment of ownership interests of the debtor.¹⁶⁹

b. Treatment of Tax Claims in the United States

The U.S. Bankruptcy Code grants a statutory priority to a wide variety of federal, state, and local tax claims. The categories of tax claims entitled to priority in a Chapter 7 or Chapter 11 case are: (1) income or gross receipts tax (three years);¹⁷⁰ (2) property tax (one year);¹⁷¹ (3) taxes required to be collected or withheld (no limit on time);¹⁷² (4) employment tax on wages, salaries, commissions (three years);¹⁷³ (5) excise tax (three years);¹⁷⁴ (6) customs [489] duties (one

¹⁶⁸ALI DRAFT STATEMENT (U.S.), *supra* note 165, at 55-56 ("Reorganization is highly favored under United States law and even more highly favored by United States legal culture and tradition. Congressional hearings and the Legislative History of the Bankruptcy Code are full of praise for Reorganization and statements of Congress's intention to encourage it. It is supported as a method for saving jobs and community values and as a device to preserve going-concern value for the benefit of creditors. . . . Most judges and Bankruptcy lawyers share this strong commitment to Reorganization."). There is significant academic and professional debate in the United States as to what the fundamental philosophy and goals of Chapter 11 are or should be. *See, e.g., id.* at 57-58; THOMAS H. JACKSON, *THE LOGIC AND LIMITS OF BANKRUPTCY LAW* (1986); Warren, *supra* note 7; G. Eric Brunstad, Jr., *Bankruptcy and the Problems of Economic Futility: A Theory on the Unique Role of Bankruptcy Law*, 55 *BUS. LAW.* 499 (2000).

¹⁶⁹*See* ALI DRAFT STATEMENT (U.S.), *supra* note 165, at 56 ("Traditionally, reorganization is devoted to saving the company itself, not merely the going concern value of its business, perhaps as a reflection of the high prestige enjoyed by entrepreneurs in United States culture. Therefore a United States Chapter 11 results in a sale of the whole business much less often than in other common law jurisdictions, although Chapter 11 fairly often results in a change or realignment of ownership in the Debtor company." (Reporter's Note omitted)).

¹⁷⁰11 U.S.C. § 507(a)(8)(A) (1994). The basic three year period depends on when a return was last due, when the tax was assessed, and whether an offer in compromise has been made with regard to payment of the taxes.

¹⁷¹11 U.S.C. § 507(a)(8)(B) (1994).

¹⁷²11 U.S.C. § 507(a)(8)(C) (1994). This includes income taxes an employer is required to withhold from an employee's wages, and an employee's share of social security and Federal unemployment insurance. It also includes state sales taxes that the debtor is required to collect from retail customers and pay over to the state. *See, e.g., Shank v. Washington State Dep't of Revenue, Excise Tax Div. (In re Shank)*, 792 F.2d 829, 830 (9th Cir. 1986) (distinguishing between two forms of sales tax liability, i.e., that which is owed personally by the retailer and is an excise tax within § 507(a)(8)(E) and that which is incurred by the retailer's customers, collected by the retailer on behalf of the state, held in trust, and remitted to the state and is within § 507(a)(8)(C)).

¹⁷³11 U.S.C. § 507(a)(8)(D) (1994). This includes an employer's share of employment tax and matching payments for social security on prepetition wages. 15 LAWRENCE P. KING ET AL., *COLLIER ON BANKRUPTCY* ¶ TX4.02[1][vi], at 4-18 (15th ed. rev. 2000).

¹⁷⁴11 U.S.C. § 507(a)(8)(E) (1994). Reclamation fee assessments in favor of the U.S., gift taxes under the Internal Revenue Code, workers' compensation premiums, sales taxes, occupation taxes, and uninsured motor vehicle assessments have been found to be excise taxes. 15 LAWRENCE P. KING ET AL., *COLLIER ON BANKRUPTCY* ¶ TX4.02[1][vii], at 4-19 (15th ed. rev. 2000). A "functional approach" is used to determine whether a government charge is a tax which is entitled to priority or a penalty, which is not. *United States v. CF & I Fabricators of Utah, Inc.*, 518 U.S. 213, 224 (1996) (ten percent "tax" on funding deficit of certain pension plans under section 4971(a) of

year);¹⁷⁵ and (7) penalties for the foregoing to the extent that they are compensation for actual pecuniary loss.¹⁷⁶

In a liquidation, priority tax claims are ranked as having "eighth priority" status and are paid after administrative expenses, certain employee wage and benefit claims, certain claims of grain producers and fishermen, consumer deposits, and alimony and child support claims.¹⁷⁷

In addition to the priorities described above, statutory tax liens generally are recognized in Chapter 7 and Chapter 11 cases and confer secured status on the federal and state taxing authorities, where a notice of tax lien has been properly filed before the petition date.¹⁷⁸ The lien attaches to all property and rights to property whether real or personal.¹⁷⁹ The lien is effective against a taxpayer immediately, but is not effective against third parties, including a bankruptcy trustee, until the notice of lien is filed.¹⁸⁰ Priority of federal tax liens is generally determined according to the rule of "first in time, first in right."¹⁸¹ Federal tax liens are treated as secured

the Internal Revenue Code was a penalty not a tax entitled to eighth priority). *See supra* note 172 (discussing priority of sales taxes).

¹⁷⁵ 11 U.S.C. § 507(a)(8)(F) (1994).

¹⁷⁶ 11 U.S.C. § 507(a)(8)(G) (1994).

¹⁷⁷ 11 U.S.C. §§ 507(a)(1)-(8), 726(a)(1) (1994).

¹⁷⁸ 11 U.S.C. § 545(2) (1994) (statutory liens are avoidable if not perfected or enforceable against a bona fide purchaser at the time a bankruptcy case is commenced). In the absence of bankruptcy, federal tax liens arise in favor of the United States by operation of law when any person liable for a tax neglects or refuses to pay after demand for payment is made. A federal tax lien attaches to all property and rights to property acquired by a taxpayer during the life of the lien. 26 U.S.C. §§ 6321-6322 (2000). The taxing authorities generally have 10 years from the date of assessment to collect a tax, unless the tax is reduced to judgment. 26 U.S.C. § 6502(a) (2000). *See In re Markham*, 74 F.3d 1347, 1353 (1st Cir. 1996) (explaining that under an earlier version of § 6502 the IRS had six years in which to seek to collect an assessed tax).

¹⁷⁹ 26 U.S.C. § 6321 (2000) (federal tax lien attaches to "all property and rights to property, whether real or personal belonging to such person."). The tax lien may even attach to assets that the debtor is otherwise entitled to exempt from the bankruptcy estate. *See In re Lyons*, 148 B.R. 88, 94 (Bankr. D. D.C. 1992) (federal tax lien extended to annuities that were otherwise exempt), *contra In re Street*, 165 B.R. 408, 409-10 (Bankr. D. Md. 1994) ("the allowed claim of the IRS is not secured by a lien on property [ERISA qualified pension plan] in which the estate has an interest").

¹⁸⁰ *See* 26 U.S.C. § 6323(a) (2000). In order for a tax lien to be "perfected" against third parties, notice must be filed in the office specified by state law. 26 U.S.C. § 6323(f) (2000). For example, in the Commonwealth of Virginia, federal tax liens against real property must be filed in the office of the clerk of the circuit court of the county or city where the real estate is located. Where liens are to be filed against personal property depends on whether the taxpayer is a corporation, partnership, or individual. VA. CODE § 55-142.1 (Michie 1995).

¹⁸¹ *See McDermott v. United States*, 507 U.S. 447, 449 (1993) (quoting *United States v. New Britain*, 347 U.S. 81, 85 (1954)). The general priority rule is qualified by a "choateness" test, which requires that a competing lien must be specific and perfected before the notice of tax lien is filed in order to take priority over the tax lien. Thus, federal tax liens will prevail over security interests in after-acquired property. *Id.* The choateness test itself is qualified by the provisions of 26 U.S.C. § 6323(c), which provides commercial lenders with priority with regard to accounts receivable for forty-five days after the notice of lien is filed.

claims in bankruptcy cases, except that in a Chapter 7 liquidation, they are subordinated to other [490] claims that are entitled to priority.¹⁸²

Prior to the commencement of a Chapter 7 or Chapter 11 case, statutory interest and penalties accrue on unpaid taxes.¹⁸³ Also, the Internal Revenue Service can use the statutorily authorized collection methods of levy and distraint through which property can be seized and sold or collected from third parties who owe money to the debtor as compensation.¹⁸⁴

Federal laws also impose third party liability on nondebtor "responsible persons" such as officers or directors who "willfully" fail to pay over taxes the debtor is required to withhold from employees' compensation.¹⁸⁵ Similarly, lenders who knowingly advance only net payroll and do not advance sufficient funds to pay withholding liabilities as well, can be held personally liable for withholding amounts.¹⁸⁶

Finally, the Bankruptcy Code excepts from an individual debtor's discharge debts for priority taxes and taxes for which no tax return was filed, for which a late return was filed, or for which a fraudulent return was filed.¹⁸⁷ Such tax claims are made nondischargeable to discourage tax avoidance through bankruptcy.¹⁸⁸ The tax priority and discharge provisions are designed to be complementary. Thus, although many tax claims are not dischargeable, they are granted priority treatment which maximizes the chance that the taxes will be paid through the liquidation proceeding and that the debtor's discharge will not be impaired.

Proper treatment of priority tax claims is prerequisite to confirmation of a Chapter 11 plan of reorganization.¹⁸⁹ In a Chapter 11 reorganization, unsecured priority tax claims must be paid in full but the debtor can stretch out the payments over six years as long as the debtor pays interest on the amount due.¹⁹⁰ Tax claims secured by liens are treated as secured claims in a Chapter 11 case. In general, this means that the secured tax claims which are otherwise priority claims must be paid in full with interest at a market rate if they are not paid in full on the effective date of the plan.¹⁹¹

¹⁸² 11 U.S.C. § 724(b) (1994). Claims entitled to priority under §§ 507(1)-(7) are given priority over the tax lien, but only to the extent of the value of the collateral. 15 LAWRENCE P. KING ET AL., COLLIER ON BANKRUPTCY ¶ TX1.10[5], at TX1-72 n.46 (15th ed. rev. 2000). *See supra* note 177 and accompanying text.

¹⁸³ 26 U.S.C. §§ 6601 & 6651 (2000).

¹⁸⁴ 26 U.S.C. § 6331 (2000).

¹⁸⁵ 26 U.S.C. § 6672 (2000). Employees are allowed a credit against their tax liability for the amount withheld, regardless of whether it is remitted to the taxing authorities by the employer. 26 U.S.C. § 31(a).

¹⁸⁶ 26 U.S.C. § 3505 (2000).

¹⁸⁷ 11 U.S.C. § 523(a)(1) (2000).

¹⁸⁸ *See supra* note 12 and accompanying text.

¹⁸⁹ 11 U.S.C. §§ 507(a)(8), 1129(a)(9)(C) (1994).

¹⁹⁰ 11 U.S.C. § 1129(a)(9)(C) (1994).

¹⁹¹ *See United States v. Haas (In re Haas)*, 162 F.3d 1087 (11th Cir. 1998) (tax claims otherwise entitled to priority are to be paid within six years even if secured by lien).

[491] 6. *Germany*

a. Insolvency Laws in Germany

Germany adopted a new Insolvency Act ("InsO") in 1994 which became effective January 1, 1999.¹⁹² Prior to that time, there was no effective procedure for reorganization under German law. The drafters of the law used U.S. Chapter 11 as a model for the reorganization provisions and were strongly influenced by the writings of Professor Thomas Jackson.¹⁹³

The statute provides for a unified proceeding, rather than separate procedures for liquidation and reorganization. When the court is satisfied that there is a basis for the proceeding and there are sufficient assets to fund the costs of administration, the court issues an order opening the proceedings and appoints an administrator (*Insolvenzverwalters*).¹⁹⁴ Upon application, the debtor can seek to administer the case as a debtor in possession under the supervision of an insolvency practitioner or supervisor, as long as this does not unduly prejudice creditors.¹⁹⁵ Secured and unsecured creditors are automatically stayed from proceeding against the debtor and its property during the first three months of the case.¹⁹⁶

Within the first three months, the administrator prepares and presents a report to the creditors who decide the further progress of the case, i.e., whether it will proceed as a liquidation or reorganization.¹⁹⁷ There is no preference in the law for reorganization over liquidation.¹⁹⁸

Individual consumers who are "good faith debtors" are eligible for discharge [492] if they cooperate with the administrator, the court, and the creditors, and make attachable assets

¹⁹²Insolvenzordnung, v. 5.10.1994 (BGBl. I S.2866) (translated in CHARLES E SEWART, ISOLVENCY CODE, ACT INTRODUCING THE INSOLVENCY CODE (1997)) (F.R.G.).

¹⁹³Kamlah, *supra* note 23, at 421 n.35 (listing certain writings of Professor Jackson, and stating that "Dr. Manfred Balz, one of the drafters of the *Insolvenzordnung* has stated that the *Insolvenzordnung* was actually a codification of Professor Jackson's theories regarding the appropriate goals of bankruptcy."). According to Dr. Balz, in enacting the *Insolvenzordnung*, "the legislature drew on an extensive comparative study of existing bankruptcy regimes, and, for the first time in German legislative history, the economic analysis of law and the precepts of institutional economics have had a direct and explicit impact on legislative policy." Manfred Balz, *The European Convention on Insolvency Proceedings*, 70 AM. BANKR. L.J. 485, 491 n.23 (1996).

¹⁹⁴InsO §§ 27, 56.

¹⁹⁵InsO § 270.

¹⁹⁶InsO §§ 86-91.

¹⁹⁷InsO §§ 156-57. If the creditors decide against reorganization, the administrator must begin to dispose of the assets. InsO §§ 158-59.

¹⁹⁸See Klaus Wimmer, *The New German Insolvency Statute: Part 1*, 29 B.C.D. A3, A8 (July 1996) ("No result of the proceedings should be given priority from the outset. Liquidation, rescuing the enterprise under new ownership and rescuing the debtor are offered as equivalent opportunities available in dealing with insolvency."). According to one of the primary drafters of the law, "the philosophy of the new law is that it is not a legitimate function of bankruptcy to maintain inefficient firms in operation where this is not in the interest of creditors, to protect the debtor from its creditors, or to replace the rigor of the general private and commercial law by some sort of vague judicial equity." Balz, *supra* note 193, at 491 n.23.

available for seven years following the termination of the proceedings.¹⁹⁹ Business debts can only be discharged through an insolvency plan.

b. Treatment of Tax Claims in Germany

There are no priority claims under the InsO. This is an enormous change from prior law, which provided priorities for, inter alia, employees, social security authorities, fiscal authorities, churches, surgeons, and children.²⁰⁰ Under the InsO, these former priority claims, including tax claims, are treated on an equal basis with other unsecured claims.²⁰¹ The logic behind the abolition of priority claims is explained by one of the authors of the government's draft of the new law:

The traditional privileges and priorities for certain classes of pre-bankruptcy creditors (typically the fiscal authorities or the workers) revalue or reinflate depreciated claims by the very fact of insolvency. Priorities in bankruptcy, as opposed to out-of-bankruptcy wealth allocation redistribute wealth under a presumed standard of equity. In line with the full recognition of pre-bankruptcy entitlements and the mandate against bankruptcy-specific revaluation of pre-bankruptcy entitlements, the new law abolishes all bankruptcy-specific priorities for pre-bankruptcy claimants. . . . Workers are protected for arrears up to three months by a special social security system financed by the noninsolvent firms in Germany (*Konkursausfallgeld*).²⁰²

Creditors with liens or claims for separate satisfaction (*Absonderungsrecht*) from assets subject to execution on real property, continue to have those rights after a case is commenced.²⁰³ The federal government, states, communities and associations of communities also have a right to separate satisfaction from assets to the extent the assets serve as security for public payments.²⁰⁴

The Federal Fiscal Code ("AO") governs collection of all taxes.²⁰⁵ As a [493] matter of practice, the taxing authorities rarely negotiate with taxpayers for deferred payment of taxes. The major collection advantage the taxing authorities have is speed. Unlike other creditors, the taxing authorities are not required to obtain a civil judgment before commencing collection procedures. Instead, if a taxpayer does not contest the amount of tax assessed, the taxing authorities can

¹⁹⁹InsO §§ 286-303.

²⁰⁰CCH EUROPE, GERMAN TAX AND BUSINESS LAW GUIDE ¶ 289-090 (1992).

²⁰¹Kamlah, *supra* note 23, at 434 ("Under new laws, these former priority claims will be dealt with on an equal basis with all other unsecured claims, thus presumably increasing the average dividend payable to general unsecured creditors.").

²⁰²Manfred Balz, *Symposium Commentary, Market Conformity of Insolvency Proceedings: Policy Issues of the German Insolvency Law*, 23 BROOK. J. INT'L L. 167, 174 & 174 n.34 (1997).

²⁰³InsO § 49.

²⁰⁴InsO § 51.

²⁰⁵Abgabenordnung (Federal Fiscal Code).

execute against movables by attachment (*Pfandung*) and can notify third parties to pay to the taxing authorities amounts that they owe to the debtor.²⁰⁶ The taxing authorities can also execute against real property by registering a lien (*Sicherungshypothek*) and carrying out the execution pursuant to the Forceable Sales and Civil Procedure Laws.²⁰⁷ The managing directors of a company can be held personally liable for unpaid taxes.²⁰⁸

7. France

a. Insolvency Laws in France

The French bankruptcy system was revamped in 1984 and 1985.²⁰⁹ The purpose of the legislation is not merely to facilitate, but actively to encourage effective reorganization of financially distressed business entities.²¹⁰

The French system is unique in that Commerce Tribunals (*Tribunaux de commerce*) generally have jurisdiction over these cases. The judges who preside are lay business people elected by the local Chambers of Commerce to serve one or more days a week as judges.²¹¹ They have practical experience and extraordinary discretionary powers.²¹²

The 1984 Law is designed to prevent business failures. It requires greater financial reporting by corporations and outside auditors to detect early warning signs of problems.²¹³ The 1994 amendments require the clerk of the Commerce Tribunal (where judgments and tax defaults are filed) to report the results to the president of the Commerce Tribunal. The Commerce Tribunal can conduct confidential mediation with creditors, which can lead to consensual arrangements.

The 1985 Law is the substantive bankruptcy law. It provides for a single unified procedure applicable to companies, merchants, artisans and farmers. The prior adversarial character of the law was removed and replaced by an [494] economic rather than legal paradigm, the explicit goals of which are (1) to save the enterprise, (2) to preserve jobs, and (3) to satisfy creditors' claims, in that order.²¹⁴

²⁰⁶AO § 309.

²⁰⁷AO § 322.

²⁰⁸AO §§ 34, 69.

²⁰⁹ Law No. 84-148 of March 1, 1984, effective March 1, 1985 [hereinafter the 1984 Law]; and Law No. 85-89, subject to Decree Nos. 85-1388 and 85-1389 of December 27, 1985 [hereinafter the 1985 Law]. Amendments were enacted in 1994. Law No. 94-475 of June 10, 1994 [hereinafter the 1994 Amendments].

²¹⁰Richard L. Koral & Marie-Christine Sordino, *The New Bankruptcy Reorganization Law in France: Ten Years Later*, 70 AM. BANKR. L.J. 437, 437 (1996).

²¹¹*Id.* at 443.

²¹²*Id.*

²¹³*Id.* at 445-48.

²¹⁴*Id.* at 442.

Proceedings under the 1985 Law must be commenced as reorganization proceedings (*redressement judiciaire*). The 1985 Law requires a six-month observation period (*période d'observation*) to determine whether or not a rescue plan is feasible. The 1994 amendments authorize the Commerce Tribunal immediately to order liquidation where business has ceased or rescue is manifestly impossible.²¹⁵ Following the commencement of the case the court holds a hearing at which it orders a stay of actions by creditors whose claims accrued before the proceedings and determines whether the case will proceed as a reorganization (*redressement*) or as a liquidation (*liquidation*). A judicial administrator (*administrateur judiciaire*), a creditors' representative, and an employees' representative are appointed and one judge is designated to oversee the case.²¹⁶ The judicial administrator's powers can vary from supervision to replacement of management.

If the case becomes a *liquidation*, the stay expires three months later (a) for creditors who have pledges, mortgages, or special preferences and (b) for the Treasury with regard to general preferences, if the liquidator has not started to liquidate the collateral within that time.²¹⁷ Upon termination of bankruptcy proceedings, prebankruptcy debts are discharged whether paid or not, except for debts for crimes, alimony, fraud, or previous filings.²¹⁸

If the case proceeds as a *redressement*, secured creditors cannot enforce their claims during the observation period or until a rescue plan (*plan de redressement*) is completed, if the court adopts one. The administrator draws up the plan in cooperation with management.²¹⁹ The court has the power to approve a proposed plan independently, selecting among plans for reorganization or sale of the business, or to order liquidation. A plan is judged simply on whether it is feasible from the debtor's perspective, not on the basis of creditor satisfaction. There is no creditor participation in the reorganization process or voting on the plan, but no creditor can be bound by a plan providing for payment of less than 100% of its claim. If a creditor does not accept the payment proposed by the plan, full payment can be extended for up to ten years.

[495] b. Treatment of Tax Claims in France

The rules governing priorities and preferences for tax authorities are found in the General Tax Code, not in the bankruptcy law. The "general preference" afforded to tax claims by the General Tax Code grants priority over other creditors with regard to the proceeds of "movable property," but not immovable property, i.e., real estate, which requires a registered mortgage to obtain priority.²²⁰

²¹⁵*Id.*

²¹⁶*Id.* at 448 n.59.

²¹⁷Laurent Gaillot, *Foreign and International Business Insolvency--France*, in MULTINATIONAL COMMERCIAL INSOLVENCY, at J-13 (1993).

²¹⁸*Id.* at J-17.

²¹⁹Koral & Sordino, *supra* note 210, at 451-53 (discussing plan formulation and approval).

²²⁰David, *supra* note 6, at 222. These tax preferences come after legal expenses, the "super preference" for employees' salaries which is granted for reasons of social justice, debts arising after the case is opened, and certain "special preferences" in particular things. *Id.* at 227-29.

The General Tax Code sets forth the tax preferences. Because these preferences are in derogation of the general principle of equality, they are interpreted restrictively.²²¹ The Tax Code includes the following preference for taxes: (1) direct taxes, such as income and gross receipts taxes (four years);²²² turnover taxes (four years);²²³ (3) registration tax and stamp duty (two years);²²⁴ (4) other indirect taxes such as taxes on beverages and spirits, taxes on sporting events and television advertisements (two years);²²⁵ and (5) customs authorities rights of confiscation, penalty, and restitution (three years).²²⁶ Social Security organizations also have a general preference for social security contributions, agricultural social security contributions, and contributions due to holiday insurance schemes.²²⁷

The Treasury must register unpaid taxes for merchants and companies with the Commerce Court on a quarterly basis.²²⁸ Registration does not determine rank vis-a-vis other taxes or creditors, but rather the general preference can be relied upon with regard to movables. The Treasury can obtain a statutory lien on immovable property which takes precedence as of the date of registration, but may only make this registration after starting collection proceedings.²²⁹

The Treasury has another tool not possessed by other creditors. Under the Procedural Tax Law, the Treasury can send out a garnishment notice to third parties who owe money to the debtor.²³⁰ The notice effects an immediate transfer to the Treasury of ownership of the claims owed by the third party to the debtor. The opening of a collective proceeding under the 1985 [496] Law does not stop the Treasury from collecting amounts covered by a notice sent out before the proceeding was opened.²³¹

Managers of companies and legal entities may be held personally liable for payment of taxes when they engaged in fraudulent activities or serious and repeated noncompliance, or when tax authorities were prevented from collecting the taxes and tax penalties due by these companies or entities.²³²

²²¹David, *supra* note 6, at 221.

²²²*Id.* at 222-24.

²²³*Id.* at 223-24.

²²⁴*Id.*

²²⁵*Id.*

²²⁶*Id.* at 224.

²²⁷*Id.* at 229-30.

²²⁸*Id.* at 225.

²²⁹CODE GENERAL DES IMPOTS, art. 1929 ter.

²³⁰LIVRE DES PROCEDURES FISCALES, art. L262 and L263.

²³¹Patrick Serlooten, *le Trésor Public, Créancier de l'Entreprise en Difficulté* [The Public Treasury, Creditor of the Financially Troubled Company], in No. 1-2 LA SEMAINE JURIDIQUE ENTREPRISES ET AFFAIRES 24, 26 (Jan. 6, 2000).

²³²LIVRE DES PROCEDURES FISCALES, art. L266 and L267.

8. Mexico

a. Insolvency Laws in Mexico

Mexico's new Commercial Insolvency Law ("LCM") became effective May 12, 2000.²³³ The LCM replaced the 1943 Law of Bankruptcy and Suspension of Payments ("LQSP"),²³⁴ and, like the prior law, applies only to legal and natural persons operating as businesses (*comerciantes*).²³⁵ In contrast to the LQSP, the LCM grants exclusive jurisdiction over commercial bankruptcy cases to the Federal District Courts rather than the state courts.²³⁶ The LCM provides for a unitary procedure applicable to all debtors which are in a state of insolvency (*concurso*),²³⁷ whereas the LQSP provided separate procedures for liquidation (*quiebra*) and suspension of payments (*suspension de pagos*).²³⁸

Upon the commencement of proceedings under the LCM, an auditor (*visitador*) is appointed to determine whether the debtor is insolvent. If the auditor finds the debtor is not insolvent, the court will refuse the application.²³⁹ If the debtor is insolvent, the court enters the concurso judgment and a conciliator (*conciliador*) is appointed who sets the time for negotiating a [497] workout agreement with the creditors.²⁴⁰ The *concurso* judgment includes (a) an order to stay further creditor payments other than administrative expenses incurred within the ordinary course of business, and (b) an order staying attachment or seizure of assets of the estate.²⁴¹ As a general rule, the debtor remains in possession and continues to administer its business during the conciliation period.²⁴² If no agreement is reached with creditors within 180 days, a trustee (*sindico*) is appointed to liquidate the business.²⁴³ Sale of the debtor's business as a going concern is preferred to piecemeal liquidation.²⁴⁴

²³³Ley de Concursos Mercantiles, D.O. (May 12, 2000).

²³⁴Ley de Quiebras y Suspension de Pagos, D.O. (April 20, 1943) (translated in 1 MEXICAN LAW LIBRARY COMMERCIAL CODES, BUSINESS AND COMMERCIAL (William D. Signet, ed. 1997)).

²³⁵It appears that personal bankruptcies will continue to be subject to state law. See Agustin Berdeja-Prieto, *Debt Collateralization and Business Insolvency: A Review of the Mexican Legal System*, in MULTINATIONAL COMMERCIAL INSOLVENCY, at O-9 (1993).

²³⁶LCM, art. 17. Under the Mexican Constitution, the federal courts have jurisdiction over commercial matters, but where only private interests are at issue, the state courts preside. While the LQSP granted jurisdiction over bankruptcy matters to the state courts, the LCM recognizes that public interests are also at stake in insolvency proceedings, such as tax and labor interests, and "federalizes" the proceedings by granting exclusive jurisdiction over bankruptcy cases to the federal courts. Carlos Sanchez-Mejorada, Remarks at The American Law Institute, Seventy-Seventh Annual Meeting, Washington, D.C., May 16, 2000.

²³⁷LCM, art. 9.

²³⁸Malcolm Rowat & Jose Astigarraga, *Latin American Insolvency Systems, A Comparative Assessment*, WORLD BANK TECHNICAL PAPER NO. 433, at 66 (1999).

²³⁹LCM, art. 48.

²⁴⁰LCM, art. 43.

²⁴¹LCM, art. 43.

²⁴²LCM, art. 74.

²⁴³The LCM provides for a Federal Institute of Bankruptcy Specialists (*Instituto Federal de Especialistas de Concursos Mercantiles*) to ascertain the credentials and make appointments of the auditor, conciliator, and trustee.

²⁴⁴LCM, art. 197.

Reorganization is highly favored under Mexican law and is supported as a method for saving jobs and preserving community values, as well as a device to preserve the going-concern value of assets for the benefit of the debtor.²⁴⁵ The LQSP, however, was severely criticized as ineffective.²⁴⁶ The LCM continues the reorganization purpose of the prior law, although it appears that there still is room for improvement in the statutory scheme.²⁴⁷

b. Treatment of Tax Claims in Mexico

The LQSP provided a complete separation of the federal tax and bankruptcy systems. Under the old regime, federal tax authorities were not subject to the bankruptcy/reorganization system and could enforce their claims in spite of the proceedings.²⁴⁸ Instead, when a bankruptcy suit, suspension of payments or insolvency suit was initiated, the court handling the case was required to give notice to the Federal Treasury which could enforce its tax [498] claims through the administrative procedure of distraint.²⁴⁹ If the tax, plus interest and penalties had been finally adjudged payable but were not paid, the government was allowed to attach and sequester assets sufficient to cover the indebtedness and proceed to sell them at auction, uninhibited by pending suspension of payments proceedings.²⁵⁰ The bankruptcy court did not participate in this and could not challenge it.²⁵¹

The LCM purports to change this to some extent. Specifically, it provides that the concurso judgment suspends attachment and seizure of assets of the estate to satisfy tax claims during the conciliation phase, although interest, fines, and penalties continue to accrue.²⁵² The taxing authorities do not vote on and are not bound by any reorganization plan negotiated with the other

²⁴⁵AMERICAN LAW INSTITUTE, TRANSNATIONAL INSOLVENCY PROJECT, INTERNATIONAL STATEMENT OF MEXICAN BANKRUPTCY LAW 97 (Tentative Draft 1998) [hereinafter, ALI DRAFT STATEMENT (Mex.)].

²⁴⁶*See* Rowat & Astigarraga, *supra* note 238, at 65 ("[The LQSP] is not widely regarded as an effective tool for salvaging a business in crisis or the value of its assets. More than once observers independently called the law an '*arma de ataque*,' an attack weapon used by unscrupulous debtors to extract concessions from creditors. Some have called it 'the worst law that has been ever enacted in the history of Mexico.' Although no statistics were presented, observers asserted that few *suspension de pagos* (the closest thing in Mexico to a reorganization) proceedings ever really succeed." (footnote omitted)).

²⁴⁷Francisco Romero, The New Proposed Mexican Bankruptcy Law 26-27 (Paper delivered at the American Bankruptcy Institute 2000 Annual Spring Meeting) (April 29, 2000) (on file with author) ("Although the current project of the LCM improves the regulation of this subject substantially, in our opinion it still falls short of what debtors and creditors deserve. . . . Although, in our opinion, the LCM structures reorganizations better than the LQSP and deviates from the bankruptcy approach, its contradictions and loopholes will make it a confusing piece of legislation.").

²⁴⁸Under the Federal Fiscal Code, the federal treasury does not participate in any actions on behalf of all creditors. *Código Fiscal de la Federación*, D.O., (December 31, 1981), art. 149 [hereinafter CFF].

²⁴⁹*Id.*

²⁵⁰CFF, arts. 152, 172.

²⁵¹ALI DRAFT STATEMENT (Mex.), *supra* note 245, at 74 n.178.

²⁵²LCM, art 69. Article 69 of the LCM does not appear to apply only to federal tax claims as it refers generally to *los créditos fiscales*.

creditors,²⁵³ but during the conciliation phase, a separate agreement can be made with the taxing authorities.²⁵⁴ If no reorganization plan is approved and the debtor's business is liquidated, the stay ceases to apply to tax claims and the taxing authorities can exercise their remedies.²⁵⁵

The LQSP specifically provided that tax claims were classified and prioritized by the tax law.²⁵⁶ Under the tax law, the federal treasury's claims are preferred over all claims except for debts guaranteed by a pledge or mortgage, alimony, salaries or wages drawn during the last year, and indemnities to workers in accordance with the federal labor law.²⁵⁷ In order to take precedence over the tax claims, guarantees must be publicly registered before the notice of fiscal indebtedness becomes effective.²⁵⁸ Pending social security credits had the same preference as federal taxes.²⁵⁹

The LCM specifically provides that all tax claims shall be paid after secured claims, "singularly privileged" claims,²⁶⁰ and administrative claims,²⁶¹ [499] unless they were guaranteed by either a mortgage or pledge, in which case they are treated as secured claims.²⁶² To the extent the LCM grants priority to administrative claims over tax claims, it appears to be inconsistent with the specific terms of the CFF, and the two statutes will have to be reconciled.

Taxes are withheld from employees' wages and paid to the government by the employer. The general directorate, the general managership, or sole administrator of companies are personally liable for withholding taxes only in limited situations.²⁶³

²⁵³LCM, art. 156.

²⁵⁴LCM, art. 152.

²⁵⁵Carlos Sánchez-Mejorada, Remarks at The American Law Institute, Seventy-Seventh Annual Meeting, Washington, D.C. (May 16, 2000).

²⁵⁶LQSP, art 261.

²⁵⁷CFF, art. 149. Under the Constitution (art. 123, Chapter A, section XXIII) and the Federal Labor Law (*Ley Federal del Trabajo*, D.O. (December 31, 1981)), claims of singularly privileged creditors (*acreedores singularmente privilegiados*) have preference even over tax claims. These claims consist of wage and benefit claims of employees and workers employed by the debtor in the year prior to the bankruptcy declaration.

²⁵⁸CFF, art. 149.

²⁵⁹CFF, arts. 2, 4, 149. The priority of state and municipal taxes was unclear. ALI DRAFT STATEMENT (Mex.), *supra* note 245, at 72.

²⁶⁰Singularly privileged claims are burial expenses and expenses incurred as a result of illness that caused the death of the *comerciante*. LCM, art. 218.

²⁶¹There are five categories of administrative claims that are to be paid in the following order: (1) labor claims (two years), (2) expenses incurred to administer the estate, (3) expenses for the protection, maintenance, and administration of the assets, (4) litigation expenses incurred to benefit the estate, and (5) the auditor's, conciliator's, and trustee's fees and expenses. LCM, art. 224.

²⁶²LCM, art. 221. This section is not limited to federal taxes and therefore could apply to state and municipal taxes as well.

²⁶³These individuals are jointly and severally liable for contributions taken or not withheld by the company during their management which cannot be guaranteed by company assets when (1) the company has not registered in the Federal Taxpayer's Registry, (2) it changed domicile without notice, or (3) it did not keep accounting records or they were hidden or destroyed. CFF, art. 26.

IV. COMPARISON OF THE TREATMENT OF TAX CLAIMS IN INSOLVENCY PROCEEDINGS

The laws of the eight countries examined reflect varying judgments about how tax claims should be treated when a business fails in a free market economy. The basic choices that have been made on the tax priority issue are compared in the table below:

A. TAX CLAIMS IN LIQUIDATION PROCEEDINGS

As reflected in the table, Germany and Australia have abolished all tax priorities.²⁶⁴ Germany's law reflects Professor Thomas Jackson's view that insolvency laws should not create any special entitlements.²⁶⁵ According to this view, the only priorities granted should be those found in the nonbankruptcy laws because bankruptcy priorities undermine the goal of collectivization. Consequently, the law contains no special priorities of any kind for [500] prebankruptcy claims.²⁶⁶ It appears that Germany has adopted this approach with the hope of increasing the average distribution to unsecured creditors when a business fails.²⁶⁷

²⁶⁴See *supra* notes 97-108 (Australia), 200-01 (Germany) and accompanying text.

²⁶⁵See *supra* note 202 and accompanying text. See also, JACKSON, *supra* note 168, at 21 ("The establishment of new entitlements in bankruptcy conflicts with the collectivization goal. Such changes create incentives for particular holders of rights in assets to resort to bankruptcy in order to gain for themselves the advantages of those changes, even when a bankruptcy proceeding would not be in the collective interest of the investor group. These incentives are predictable and counterproductive because they reintroduce the fundamental problem that bankruptcy law is designed to solve: individual self-interest undermining the interests of the group. These changes are better made generally instead of in bankruptcy only.") (emphasis in original); DOUGLAS G. BAIRD, *THE ELEMENTS OF BANKRUPTCY* 86 (1992) ("As a general matter, special priority rules in bankruptcy seem hard to justify, but, except for tax obligations, they do not loom large. Even in a case in which a debtor has significant tax obligations, the special bankruptcy priority the tax obligations are accorded may be irrelevant if a tax lien is already in place.").

²⁶⁶Employee claims are paid from a special fund to which all employers make contributions. See *supra* note 202 and accompanying text.

²⁶⁷See *supra* note 201 and accompanying text.

Table

Summary of Tax Priorities Under National Insolvency Laws

	Withholding (PAYE / Sales / RWT / NRWT)	Indirect		Direct		Other
		VAT / Sales	Excise / Customs	Soc Sec / Pension / Payroll	Income / Gross Receipts	
United States	•	•	•	•	•	•
France	•	•	•	•	•	•
Mexico	•	•	•	•	•	
England	•	•	•	•		
New Zealand	•	•*	•*			
Canada	•					
Australia						
Germany						

•Insolvency law provides priority for payment of these taxes.

*Repeal of priority for these taxes has been recommended.

Although Australia retains a priority for employee claims,²⁶⁸ it has abolished all tax priorities. At the same time, however, it strengthened its tax administration rules in certain ways.²⁶⁹ First, it allows the taxing authorities to initiate involuntary insolvency proceedings when the tax is still an "uncertain amount," whereas previously taxing authorities could only initiate proceedings when the amount owed had been fixed. Second, it imposes personal liability on company directors for unremitted withholding taxes. Finally, it recognizes that certain taxes, such as real estate taxes, may become liens by statute and obtain priority through their secured status.

England, Canada, and New Zealand have eroded and refined their bankruptcy priority rules for tax claims, each after considerable study and analysis of the issues involved.²⁷⁰ Given the common origin of their legal systems, it is not surprising that the study reports for these

²⁶⁸ See *supra* notes 100-08 and accompanying text.

²⁶⁹ See *supra* notes 110-11 and accompanying text.

²⁷⁰ See *supra* notes 77 (England), 127 (New Zealand), 151 (Canada) and accompanying text.

countries, as well as Australia, often rely on similar analyses and cite each other. England, Canada, and New Zealand, like Australia, agree that no special priority should be granted to direct income taxes, but retain a bankruptcy priority for employee claims. Unlike Australia, however, they have concluded that taxes collected from [501] and withheld on behalf of third parties such as employees, should be entitled to a special bankruptcy priority when a business fails. Of the three, only England imposes a specific time limit on the period of the withholding tax priority.²⁷¹

Withholding taxes are the single category of taxes entitled to priority in Canada, where they are granted priority over secured as well as unsecured claims, except for preexisting liens on real property.²⁷² This is also the single category of tax priorities that the New Zealand Law Commission recommends be retained.²⁷³ The Law Commission reasons that it is unfair to the persons whose entitlements were withheld not to assure payment of these amounts because such persons have "ordered their affairs on the assumption that the taxes have been paid."²⁷⁴ Further, the Law Commission believes it is unfair to allow the assets of the insolvent's estate to be increased through the use of monies the debtor ought to have paid on behalf of third parties.²⁷⁵

In England, priority also is granted for various excise taxes that are due within a year before the commencement of an insolvency proceeding, as well as six months of value added taxes.²⁷⁶ Although the priority for value added taxes has been retained, the period of the priority has been reduced from one year to six months to reflect more accurately the shorter reporting cycle for these taxes, which should provide the taxing authorities with notice of any delinquencies.²⁷⁷ The New Zealand Law Commission has recommended that priorities for customs duties and the goods and services tax be eliminated because the traditional justifications, public interest and involuntary creditor, do not justify their retention.²⁷⁸ Although Canada currently does not provide a priority for its general sales taxes, the propriety of treating these taxes differently than withholding taxes in Canada has been questioned.²⁷⁹

The United States, France, and Mexico retain bankruptcy priorities for a wide variety of tax claims and social security contributions, in cases of insolvency.²⁸⁰ Each of these countries also

²⁷¹ See *supra* note 69 and accompanying text.

²⁷² See *supra* notes 153-54 and accompanying text.

²⁷³ See *supra* note 135 and accompanying text. The Law Commission recommends that the priority for PAYE become part of the priority for employee wage claims in company insolvencies, and be extended to personal insolvencies. It recommends that a separate priority be maintained for RWT and NRWT.

²⁷⁴ *Id.* This would only be the case if the employees are not given credit for the tax withheld. Compare 26 U.S.C. § 31(a) (under U.S. law, employees are entitled to a credit for taxes withheld from their compensation regardless of whether such taxes are in fact remitted to the government).

²⁷⁵ See *supra* note 135 and accompanying text.

²⁷⁶ See *supra* notes 71-73, 76, 78 and accompanying text.

²⁷⁷ See *supra* note 78 and accompanying text.

²⁷⁸ See *supra* notes 121, 123-25, 132-34 and accompanying text.

²⁷⁹ See *supra* note 153 and accompanying text. The distinction may turn on whether the tax is imposed directly on the debtor or is merely collected by the debtor. See *supra* note 172 and accompanying text.

²⁸⁰ See *supra* notes 170-76 (U.S.), 222-27 (France), 257-59 (Mexico) and accompanying text.

maintains priorities for employee wage [502] and benefit claims as part of an extensive set of priority rules.²⁸¹ The priority systems, however, differ in several respects.

First, the countries differ as to where the priority rules are found. In the United States, all of the special bankruptcy priorities are set forth in a single section of the bankruptcy law.²⁸² In France, the bankruptcy law, the civil code, and various sections of the tax code must be consulted in order to determine the priority scheme.²⁸³ In Mexico, the priorities are found in the tax code and the labor law, as well as the insolvency law.²⁸⁴

Second, the taxes entitled to priority differ in each country. In the United States and France, different types of taxes are entitled to priority for different periods of time.²⁸⁵ In the United States, in general the priority periods are longer where the administration and collection process is more complex and time consuming, or where the taxes are of a quasi-trust nature.²⁸⁶ For example, there is no specific limit on the priority period for withholding taxes. Also, a longer priority period is allowed for income taxes where self-assessment is required, whereas a shorter period applies for ad valorem taxes on property such as real estate taxes and customs duties, where the taxing authorities can readily impose liens on or detain the property subject to tax. In Mexico, on the other hand, all federal taxes are entitled to priority under the Federal Fiscal Code, subject only to the applicable statute of limitations for collection.²⁸⁷

Third, what the priority means in a liquidation differs in each of the three countries. In the United States,²⁸⁸ priority taxes are paid after creditors properly secured by real or personal property, administrative claims, and certain employee wage and benefit claims, but ahead of general unsecured creditors. The priority is available regardless of whether a tax lien was filed prior to the bankruptcy case. If the taxing authority has recorded a notice of tax lien prior to bankruptcy, the taxes secured by the lien are paid based upon priority of the lien, subject to special rules that subordinate the tax lien to other priority claims. In individual bankruptcy cases, the priority taxes are not dischargeable.

In France, taxes must be registered in order to claim the "general preference" for tax claims. When the taxes are registered, the tax claims are entitled to priority with respect to personal property (*movables*), but have no [503] priority with respect to real property (*immovables*), unless the tax claims are registered in the mortgage office after collection proceedings are

²⁸¹ See *supra* notes 177 (U.S.), 220 (France), 257-61 (Mexico) and accompanying text.

²⁸² See *supra* notes 170-77 and accompanying text.

²⁸³ See *supra* notes 220-27 and accompanying text.

²⁸⁴ See *supra* notes 257, 260-61 and accompanying text.

²⁸⁵ See *supra* notes 170-76 (U.S.), 221-27 (France) and accompanying text.

²⁸⁶ HOUSE REPORT (U.S.), *supra* note 8, at 190-93.

²⁸⁷ See *supra* note 257 and accompanying text.

²⁸⁸ See *supra* notes 170-77 (priorities), 178-82 (tax liens), 187-88 (not dischargeable) and accompanying text.

commenced.²⁸⁹ These general preferences are paid after administrative expenses, a special wage priority, and possibly other special priorities that attach to specific personal property.²⁹⁰

In Mexico, the priority scheme described in the LCM which purports to cover all tax claims (*los creditos fiscales*), differs somewhat from the priority scheme in the CFF, which applies only to federal taxes.²⁹¹ Under the LCM, tax claims are ranked after claims guaranteed by a pledge or mortgage, burial and certain medical expenses, and administrative expenses which include two years of labor claims plus expenses related to the administration of the bankruptcy estate.²⁹² Under the CFF, tax claims are to be paid after secured claims, wages and salaries incurred within one year, indemnities to workers in accordance with the federal labor law, and alimony.²⁹³ If no agreement is reached with creditors and the debtor's business is liquidated, the taxing authorities can enforce tax claims unimpeded by the pendency of insolvency proceedings.²⁹⁴

B. TAX CLAIMS IN REHABILITATION PROCEEDINGS

The seven countries that have insolvency laws providing for some kind of generally available rehabilitation or reorganization all provide for a stay of further collection efforts by tax authorities upon the commencement of a proceeding.²⁹⁵ In New Zealand, where there is no generally available administration procedure, it appears that collection efforts by taxing authorities may be subject to a moratorium only in the government-imposed statutory management procedure.²⁹⁶

Five of the countries have rules that can require the tax authorities to accept payment of their tax claims over time. The laws of the United States and Canada provide that payment of priority tax claims can be stretched out (over six years in the United States and over six months in Canada), but that [504] interest must be paid on these claims.²⁹⁷ In France, creditors, including taxing authorities, which do not accept a reduced payment, can be forced to accept payment over ten years under a reorganization plan.²⁹⁸ In Australia and Germany, where taxes are treated as unsecured claims, the taxing authorities may vote on a proposed deed of company arrangement or plan, respectively, but are bound to accept the same treatment as other unsecured creditors,

²⁸⁹ See *supra* notes 228-29 and accompanying text.

²⁹⁰ See *supra* note 220 and accompanying text.

²⁹¹ See *supra* notes 256-59 and accompanying text. The main categories of federal taxes are income tax, business assets tax (similar to a minimum income tax), and value added tax. Property taxes are levied by the states and Federal District, as are certain payroll taxes. Manuel E. Tron, *The Mexican Tax System*, in 2 MEXICAN LAW LIBRARY COMMERCIAL CODES, TAX 747, 749 (William D. Signet, ed. 1997); See *supra* notes 248-51 and accompanying text.

²⁹² See *supra* note 260-62 and accompanying text.

²⁹³ See *supra* note 257 and accompanying text.

²⁹⁴ See *supra* note 255 and accompanying text.

²⁹⁵ See *supra* notes 58, 61-62 (England, except that there is no stay in CVA proceeding), 92-93 (Australia), 149 (Canada), 162 (U.S.), 196 (Germany), 217 (France), 252 (Mexico) and accompanying text.

²⁹⁶ See *supra* notes 115, 119 and accompanying text.

²⁹⁷ See *supra* notes 157 (Canada), 190-91 (U.S.) and accompanying text.

²⁹⁸ See *supra* note 219 and accompanying text.

unless their claims have risen to the status of enforceable and nonavoidable liens. The same is true of the nonpriority portion of tax claims in Canada and the United States.

In England, the government must agree to delayed payment as part of a CVA, but as a practical matter it is likely to agree if it concludes it will receive more than in a liquidation.²⁹⁹ In New Zealand, which really does not have a modern reorganization law, the government must agree to delayed payment of its taxes. In Mexico, the law does not require the taxing authorities to accept delayed payment but does contemplate the negotiation of an agreement for payment of taxes.³⁰⁰

V. ISSUES TO CONSIDER IN EVALUATING OR DESIGNING RULES FOR THE TREATMENT OF TAX CLAIMS IN INSOLVENCY PROCEEDINGS

The IMF Report identifies two overall objectives of effective insolvency laws. The first overall objective is to allocate risks among the participants in a market economy in a way that is predictable, equitable, and transparent.³⁰¹ For rules to be predictable, they should be clearly specified and consistently applied. For rules to be equitable, they should reflect the bargain made with the debtor relative to the other participants. This does not mean that all creditors should be treated equally. Where creditors have made fundamentally different bargains with the debtor, different treatment may be needed for the system to be equitable. Finally, for rules to be transparent, they should give participants sufficient information to exercise their legal rights.

The second overall objective of effective insolvency laws is to protect and maximize value for the benefit of all interested parties and for the economy in general.³⁰² The most obvious way to pursue this goal is through rehabilitation procedures that continue the existence of viable businesses. This may result in the reorganization of an existing entity or the sale of its business as a [505] going concern. Where a business is not viable, it should only be continued under the most exceptional circumstances.

The different treatments of tax claims in the laws considered and the recent history of their revisions reflect varying judgments as to how these objectives might be achieved. The history of these revisions further reveals the issues and competing policy considerations that have guided these judgments and also suggests conclusions.

First, the priority rules adopted appear not to depend on whether the country has a civil or common law tradition. Germany and Australia, which are civil and common law countries, respectively, have the fewest bankruptcy priorities for tax claims. At the other end of the spectrum, France, a civil law country, and the United States, a common law country, have the most priorities.

²⁹⁹ See *supra* note 81 and accompanying text.

³⁰⁰ See *supra* note 254 and accompanying text.

³⁰¹ IMF REPORT, *supra* note 1, at 5-6.

³⁰² *Id.* at 6-8.

Second, although labeling an insolvency system as "creditor oriented" or "debtor oriented" can be misleading, countries that traditionally have been characterized as creditor oriented generally have fewer bankruptcy priorities for taxes than countries that have been labeled as debtor oriented.³⁰³ This may be explained in part because granting fewer categories priority treatment is consistent with providing the remaining creditors with a better return in a liquidation.

Third, there is a recent trend to reduce tax priorities, at least in the four commonwealth countries and in Germany.³⁰⁴ In the commonwealth countries this trend appears to be based on the view that the government does not need the revenue at the expense of other creditors and can make up for its position as an "involuntary creditor" by using the special collection tools it has at its disposal. Germany's move to abolish all priorities for prebankruptcy claims is bolder. It is an economic experiment based on an academically inspired policy judgment that prebankruptcy entitlements should not be reordered in the event of insolvency.³⁰⁵ It is possible that in times of general economic prosperity and budget surpluses, this trend could gain greater momentum [506] and the tax priority could find less favored treatment because the government's revenue needs are not as great.

Effective tax administration rules and enforcement are important to equalize the government's "involuntary creditor" disadvantage, particularly where tax priorities are eliminated. Thus, where a country's tax administration rules are not effectively designed or enforced, eliminating the tax priority could place the government in a worse position than other creditors in collecting its revenue claims. Where the government's revenue needs exceed its ability to collect revenues outside of bankruptcy and insolvent companies are significantly in arrears, the choice may be made to retain a bankruptcy tax priority to minimize the losses to the general public.

Fourth, there appears to be agreement that amounts withheld from third parties which are to be paid over to the government by the debtor should be afforded special treatment, whether

³⁰³WOOD, *supra* note 3 (ranking countries on a scale of 1 to 10, with 1 the most pro-creditor and 10 the most pro-debtor: Australia (2), England (2), Germany (3), New Zealand (4), Canada (5), United States (5), most of Latin America (8), and France (10)).

³⁰⁴Given the fact that the tax priority has come under attack in other common law countries, it is noteworthy that proposed amendments to the U.S. Bankruptcy Code that were recently considered by the U.S. Congress do not propose any reductions of the current tax priorities in bankruptcy cases. *See* H.R. 833, 106th Cong. (1999) and S. 625, 106th Cong. (2000). Neither was the priority questioned in the 1997 Report of the National Bankruptcy Review Commission. NATIONAL BANKRUPTCY REVIEW COMMISSION, BANKRUPTCY: THE NEXT TWENTY YEARS, NATIONAL BANKRUPTCY REVIEW COMMISSION FINAL REPORT 943 (1997), *available at* <<http://www.nbrc.gov>> (last visited Jan. 8, 2001) (recommendations regarding tax issues). This may reflect the fact that very little empirical data is available on the effect of these priorities in business bankruptcy cases, and consequently a reluctance to question them. *See infra* note 306.

³⁰⁵*See supra* notes 193 and 202 and accompanying text.

through a specific bankruptcy priority, a trust theory, the imposition of third party personal liability, or a combination of the foregoing.

Fifth, if special bankruptcy tax priority rules are chosen, they should be transparent, of appropriate duration, and coordinated with the tax administration rules. Locating all of the rules in a single statute that applies when bankruptcy is filed rather than relying on multiple statutory liens and related provisions would make the scheme more comprehensible to creditors--who need to take the risk of tax priorities into account in dealing with the debtor. Requiring registration of tax liens would enable creditors who are extending credit to determine the extent of a debtor's delinquent taxes and make more informed credit decisions. As to duration of the priority, consideration should be given to the reporting and collection cycle for the taxes in order to avoid lax enforcement.

Sixth, special rules for rehabilitation proceedings should be considered. Giving the debtor breathing space by staying the collection of taxes, and specifically providing for an extended payment of arrearages as part of a plan of rehabilitation, can serve the goal of encouraging viable businesses to reorganize.

CONCLUSION

This Article has identified a number of issues relevant to the appropriate treatment of tax claims in insolvency proceedings, and considered how these issues have been addressed under the laws of eight countries.

The choices made clearly depend on a range of factors. However, informed choices on a number of these issues can only be made with the aid of statistical information concerning payments to creditors, including tax claims in liquidation and rehabilitation proceedings. Even in an industrialized country [507] such as the United States, very little empirical data has been made regularly available on which to base these legislative decisions.³⁰⁶ It is hoped that, along with the many other issues to be addressed concerning the design of orderly and effective insolvency laws, the importance of such information will be recognized so that data will begin to become available to assist those charged with making policy decisions on priorities for tax claims in bankruptcies.

³⁰⁶Elizabeth Warren and Jay Lawrence Westbrook, *Financial Characteristics of Businesses in Bankruptcy*, 73 AM. BANKR. L.J. 499, 506-07 (1999) (The authors describe a wide ranging "Business Bankruptcy Project" being undertaken to collect empirical data about business bankruptcies in the United States, noting "the paucity of empirical data about the business bankruptcy process." The authors observe that "aside from the very limited annual statistics published by the Administrative Office of the U.S. Courts, there have been few data reported by the government. Ironically, although the United States bankruptcy system is one of the most studied and most debated--pro and con--all over the world, it is the subject of very little empirical research at home. . . . Our feeling is that an institution as important to the economy of a nation as the bankruptcy laws should not be changed materially based on thought experiments.").