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BY GEORGE H. SINGER

Tax and You Shall Receive

How the Federal Priority Statute Can Upset Receiver and Lender Expectations



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The Federal Priority Statute (FPS), codified at 31 U.S.C. § 3713, is an often-overlooked statute applicable in nonbankruptcy insolvencies, including receiverships and assignments for the benefit of creditors. The FPS “is almost as old as the Constitution, and its roots reach back even further into English common law.”¹ A failure on the part of receivers, corporate fiduciaries, lenders and counsel to understand the FPS and appreciate its potential impact in financings or insolvencies can have serious consequences.

Under the federal priority statute, the federal government enjoys a right of priority in payment upon distribution of an insolvent debtor’s estate who is not in bankruptcy. When applicable, the FPS subordinates the debts of others to the claims of the federal government. The statute also imposes personal liability on fiduciaries, such as officers, directors and receivers, in certain circumstances for failing to comply with the law’s mandate.

Receiverships

A receivership is a remedy often employed by a secured creditor upon the default or insolvency of a borrower. Receivers are appointed by federal and state courts in a variety of contexts with duties that include the collection, preservation, administration and, often, liquidation and distribution of assets.

A receiver in possession of the assets of the debtor typically is treated as having stepped into the debtor’s shoes. Often put in place upon the request of a secured creditor, a receiver owes a fiduciary

duty to all parties-in-interest, including taxing and other governmental authorities, not just the party who sought the appointment of the receiver.

The Rule of Priority

The FPS — which is applicable if a debtor has insufficient assets to cover all debts — mandates that a “claim of the [U.S.] Government shall be paid first when — (A) a person indebted to the Government is insolvent and — (i) the debtor without enough property to pay all debts makes a voluntary assignment of property; (ii) property of the debtor, if absent, is attached; or (iii) an act of bankruptcy is committed; or (B) the estate of a deceased debtor, in the custody of the executor or administrator, is not enough to pay all debts of the debtor.”²

However, the statute is silent with respect to its impact on creditors that hold prior liens perfected on the debtor’s property. As such, its application to priority battles and the defenses thereto are currently still in the gray area.³

A “claim” under the FPS is broadly defined as “any amount of funds or property that has been determined by an appropriate official of the Federal Government to be owed to the United States.”⁴ The statute applies whether the government’s claim is liquidated, matured or neither.⁵

¹ *United States v. Moore*, 423 U.S. 77, 80 (1975). See Claire Schenk, “Addressing the Language and Scope of the Federal Priority Act,” 44 *The Fed. Lawyer* (May 2015) (indicating that FPS was enacted shortly after Revolutionary War, at a time when “many persons had necessarily become indebted to the United States”).

² 31 U.S.C. § 3713 (emphasis added).

³ See Claire Schenk, “The Federal Priority Act: How ‘Secure’ Is a Secured Creditor if the Debtor Is Subject to a Federal Claim or Investigation?,” Thompson Coburn LLP Blog (Oct. 10, 2018), [thompsoncoburn.com/insights/blogs/credit-report/post/2018-10-10/the-federal-priority-act-how-secure-is-a-secured-creditor-if-the-debtor-is-subject-to-a-federal-claim-or-investigation](https://www.thompsoncoburn.com/insights/blogs/credit-report/post/2018-10-10/the-federal-priority-act-how-secure-is-a-secured-creditor-if-the-debtor-is-subject-to-a-federal-claim-or-investigation) (last visited Nov. 19, 2024).

⁴ 31 U.S.C. § 3701(b)(1). Courts have expansively interpreted the term and “applied the priority statute to Government claims of all types.” *United States v. Moore*, 423 U.S. 77, 80 (1975). *Cf.*, 11 U.S.C. § 101(5)(A), (B) (broadly defining term “claim” under Bankruptcy Code).

⁵ *Moore*, 423 U.S. at 80-83.

Its breadth means that any federal tax liability or financial claim of the U.S. having priority must be paid before a fiduciary pays other creditors.

The priority rule contained in the statute supersedes requirements of inconsistent state law, including those that require withholding and payment of past-due sales taxes, as one example.⁶ The statute does not, however, apply to cases under title 11, as the Bankruptcy Code has established priorities for allowed claims.⁷ Where multiple entities owned by the same person have assigned assets to a third party for the benefit of creditors, but only one of the two companies was subject to claims of the federal government, the government's priority also only extends to that segment of the proceeds corresponding to the value of the assets subject to the FPS claim.⁸

The FPS is intended to secure adequate revenue to satisfy burdens on the federal treasury; as such, it is generally construed liberally in the government's favor.⁹ The statute has been deemed "almost as old as the Constitution" itself, but, notwithstanding its age, priority disputes between secured creditors and the federal government remain. In addition, the issue of whether the FPS has any application to antecedent perfected liens has never been answered definitively.¹⁰

Exceptions

The federal statute granting priority to claims of the U.S. does not create a lien upon the debtor's property, it merely grants a right of priority in payment of the funds in the estate. Despite the statute's seemingly simple and unequivocal language, courts have acknowledged the existence of certain exceptions to the absolute-priority rule under the FPS.

One exception that has developed is for a *bona fide* transfer, pledge or lien that is perfected *before* the right of preference of the U.S. attaches — in other words, a claim that is sufficiently specific and perfected before the right of preference accrued to the U.S. generally prevails.¹¹ The rule then can be generally expressed as follows: In nonbankruptcy insolvencies, such as receiverships and assignments for the benefit of creditors, the U.S.'s claim is entitled to priority over any creditor claim except for those claims of properly perfected lien creditors.¹²

The priority afforded the federal government under the FPS is triggered unless another federal statute creates an exception or alternate framework. In other words, the FPS does not apply to disputes that fall under other statutes. For example, the Internal Revenue Code includes its own

priority and enforcement mechanisms under which a tax lien arises on the date when unpaid taxes are assessed.¹³ The lien attaches to all taxpayer property and becomes effective against third parties on the date that notice of the lien is recorded.

The Federal Tax Lien Act of 1966 (FTLA), like the Uniform Commercial Code, adopts a "first-in-time" rule such that a purchaser, holder of a security interest, mechanic's lien or judgment lien creditor is protected against a federal tax lien where notice of the tax lien has not been filed, notwithstanding actual knowledge of the tax lien.¹⁴ A federal tax lien will take priority over most other valid liens in property that has not yet come into existence — after-acquired property, for example — unless such property represents proceeds of the asset subject to an earlier, perfected lien.¹⁵

In view of the statutory scheme created by the FTLA, the U.S. Supreme Court in *United States v. Estate of Romani* held that the FTLA was the governing statute when the government claimed a preference in the insolvent estate of a delinquent taxpayer based on a tax lien; therefore, an unrecorded federal tax lien did not have priority over a judgment lien that had been perfected under state law.¹⁶ Where the federal tax claim has been found to be governed by the FTLA, the FPS has been held inapplicable to defeat a competing priority claim.

The *Romani* Court noted that the FTLA solidified Congress's intent to broaden the protection of secured creditors from federal liens when no notice of those liens would have been available to the secured creditor. As such, a lien properly perfected under state law will have priority over a later-filed federal tax lien. However, a lien that is not choate or is unperfected under state law does not have priority over a filed federal tax lien.

Personal Liability

A failure on the part of a receiver or other representative to foresee the applicability of the FPS or FTLA can be costly. Under the FPS, a fiduciary who knew (or should have known) of the existence of federal claims, including tax claims, might be held personally liable for paying any debt of the person or estate before paying a federal claim to the extent of the unpaid federal claim.¹⁷ In other words, it is clear that the knowing failure to honor the priority in nonbankruptcy insolvencies is done at the fiduciary's personal risk.¹⁸

There is one exception to this rule. While the FPS's mandate imposes liability on representatives of insolvent estates for making disbursements to anyone ahead of the govern-

6 See, e.g., *United States v. Cole*, 733 F.2d 651, 654 (9th Cir. 1984).

7 31 U.S.C. § 3713(2)(b); 11 U.S.C. §§ 506, 507.

8 *Cole*, 733 F.2d at 651.

9 *Bramwell v. United States Fid. & Guar. Co.*, 269 U.S. 483, 487 (1926).

10 See *United States v. Key*, 397 U.S. 322, 332, n.11 (1953).

11 See *Straus v. United States*, 196 F.3d 862, 864 (7th Cir. 1999). *Accord*, *In re Metzger*, 709 F.2d 32, 34-35 (9th Cir. 1983) (priority right of government did not attach until after competing interest and claim was perfected).

12 See generally *United States v. Kimbell Foods Inc.*, 440 U.S. 715, 718-30, 740 (1979) ("[A]bsent congressional directive, the relative priority of private liens and consensual liens arising from ... Government lending programs is to be determined under nondiscriminatory state laws."); *KS Fin. Grp. Inc. v. Schulman*, 73 F. Supp. 2d 1373, 1377 (N.D. Ga. 1999) (acknowledging that Supreme Court itself indicated that issue remained undecided, but refusing to give priority to government tax liens because secured creditor "did all that it could do under [state] law to perfect its lien. [so] its lien was therefore perfected in the sense that there is nothing more to be done to have a choate lien").

13 See 26 U.S.C. §§ 6321, 6322.

14 See *Revenue Ruling 2003-108*.

15 See *United States v. McDermott*, 507 U.S. 447, 449-50 (1993).

16 523 U.S. at 533-34.

17 31 U.S.C. § 3713(b). See *Internal Revenue Serv. Manual*, Part 5 § 5.5.1.6(4). See also *United States v. Cole*, 733 F.2d 651, 654 (9th Cir. 1984).

18 When it is a company distributing its assets prior to satisfying its debts to the government, the potentially liable representatives of the company are its directors, officers and managers. See *United States v. Golden Acres*, 684 F. Supp. 96, 101-02 (D. Del. 1988). See also *United States v. Neuberger*, No. EA-22-2977, 2024 U.S. Dist. LEXIS 154264, at 1 (D. Md. Aug. 27, 2024) (United States initiated action to assert claim of personal liability against individual who served as director, officer and counsel to company that had outstanding tax liability for making payments to other creditors under FPS).

19 The purpose for imposing personal liability on a debtor's representative "is to make those into whose hands control and possession of the debtor's assets are placed, responsible for seeing that the Government's priority is paid." *King v. United States*, 379 U.S. 329, 337 (1964).

ment,¹⁹ courts have ruled that costs of administration take precedence over the government's priority.²⁰ It nevertheless remains good practice to inform the Internal Revenue Service or other government creditor of various administrative payments to ensure that there are no issues and to have the court approve the payments and make a finding as to their reasonableness.

Breadth of Statute

It is important to recognize that the FPS affords priority to the federal government for "claims" in contexts other than unpaid income taxes. Different government agencies have invoked the FPS in a variety of situations. Debts arising for withholding taxes,²¹ estate taxes, breach of contract,²² financings under government loan programs, or health care settings and environmental laws²³ would be examples.²⁴

While the term "claim" in the FPS is intentionally expansive, it is not unlimited in scope. The government only has a claim if the debt owed to the federal government exists at the time of the "act of insolvency."²⁵ Debts that do not arise until after the act of bankruptcy have occurred do not meet a definition of a "claim" under the FPS.²⁶ In addition, the government's claim of priority might be applicable even when it is contested, or it is not yet formally assessed or is reduced to an amount certain. Therefore, sometimes it might be difficult to determine the timing of the "claim" given the fact that the claim of priority may exist regardless of whether the amount of debt has been precisely determined.

Therefore, the risk of personal liability and responsibilities attendant in administering a receivership estate requires extra vigilance in determining when a claim in the U.S.'s favor exists. The FPS's potential application mandates care and considerations relative to adequate notice, communication with the federal government, and language of proposed court orders. For example, the record should be supported by adequate factual findings when funds of the estate will be used and distributions are made.

Conclusion

The FPS is not a widely known statute despite the fact that it existed at the time when America was formed. Yet it can have immense importance for insolvent companies and their officers, directors and receivers, as well as creditors expecting an ultimate distribution. The statute's

scope and narrow class of available exceptions, most of which have developed due to courts interpreting the FPS, need to be understood by those dealing with insolvent companies. **abi**

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²⁰See, e.g., *Abrams v. United States*, 274 F.2d 8, 12 (8th Cir. 1960); *In re Receivership of Hollingsworth*, 386 N.W.2d 93, 97 (Iowa 1986) (ruling that "government's priority is subject to proper receivership expenses"). The Internal Revenue Service has appeared to concede this point. See *Internal Revenue Serv. Manual*, Part 34 § 4.1.7 (discussing 31 U.S.C. § 3713(a) and providing that "[e]xceptions to 31 U.S.C. § 3713(a) include ... b. Administrative Expenses").

²¹ See, e.g., *United States v. Sperry*, No. 1:12-CV-0020-JMS, 2013 WL 1768664, *3 (S.D. Ind. April 24, 2013).

²² See, e.g., *United States v. Renda*, 709 F.3d 472, 485 (5th Cir. 2013) (affirming court order finding insolvent company liable to government under FPS for amount of assets transferred to creditors in breach-of-contract case).

²³ See, e.g., *Burns v. Burns Iron & Metal Co.*, No. S-12-024, 2013 WL 2152524 (Ohio Ct. App. May 17, 2013) (observing that Environmental Protection Agency invoked FPS when Comprehensive Environmental Response, Compensation, and Liability Act claim was asserted against company and insiders entered into stock redemption agreements providing for payment).

²⁴ See, e.g., *United States v. Adaptive MicroSystems LLC*, 914 F. Supp. 2d 1331, 1335 (Ct. Int'l Trade 2013) (government claiming priority for unpaid dues attributable to misclassified imports).

²⁵ 31 U.S.C. § 3713(a)(1)(A)(iii).

²⁶ See, e.g., *In re Metzger*, 709 F.2d 32, 34-35 (9th Cir. 1983) (concluding that because debt owed to U.S. did not exist until after act of bankruptcy, government could not state claim under FPS).