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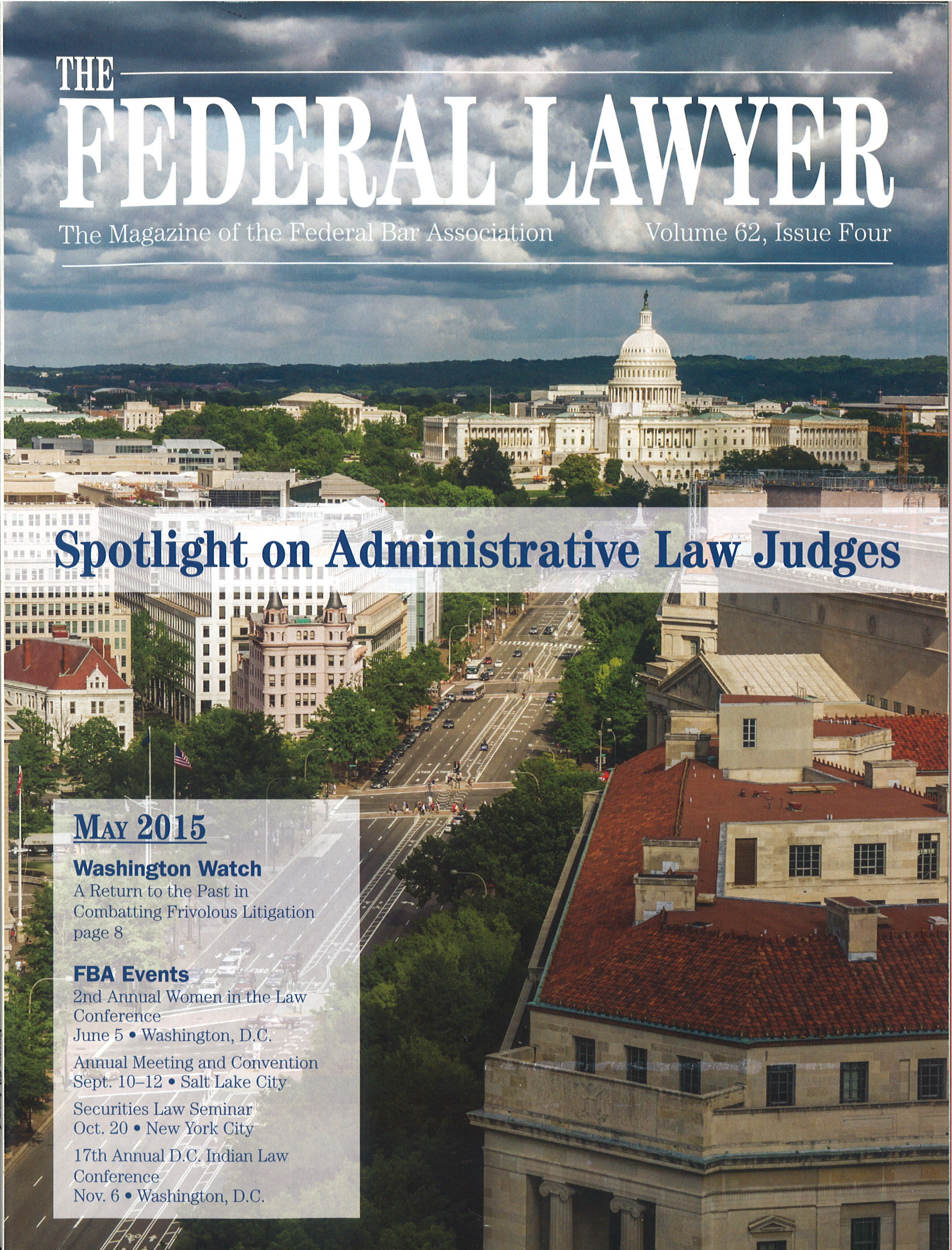

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2nd Annual Women in the Law Conference
June 5 • Washington, D.C.

Annual Meeting and Convention
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Securities Law Seminar
Oct. 20 • New York City

17th Annual D.C. Indian Law Conference
Nov. 6 • Washington, D.C.

Addressing the Language and Scope of the Federal Priority Act

By Claire Schenk

The Federal Priority Act "is almost as old as the Constitution, and its roots reach back even further into the English common law" (*United States v. Moore,* 423 U.S. 77, 80 (1975)). It was enacted soon after the Revolutionary War, at a time when "many persons had necessarily become indebted to the United States" (*United States v. Fisher,* 6 U.S. (2 Cranch) 358, 392, (1805)). Some courts discussing the statute's long history have even gone so far as to say that the FPA was part of the "early efforts of the founding fathers to make this country a union and not a confederation of states" (*United States v. Lutz,* 295 F.2d 736, 742 (5th Cir. 1961)).

The FPA, 31 U.S.C. § 3713, mandates that federal government claims receive first priority for payment when two conditions are satisfied: (1) the federal government's debtor is insolvent, and (2) either (a) the debtor without enough property to pay all debts makes a voluntary assignment of property, (b) the property of the debtor, if absent, is attached, or (c) an act of bankruptcy is committed (31 U.S.C. § 3713(a))[2]. The government debt must be in existence when the insolvent debtor assigns his property, has his property attached, or commits an act of bankruptcy (*Guillermety v. Sec. of Educ. of U.S.*, 241 F. Supp. 2d 727, 733 (E.D. Mich. 2002)). If the above conditions are satisfied, the government may hold the insolvent debtor's representatives liable to the extent of any payments made in derogation of the government's priority. *See* 31 U.S.C. § 3713(b).

The statute of limitations for an action against a representative under 31 U.S.C. § 3713(b) is six years (28 U.S.C. § 2415; *see U.S. v. Moriarty*, 8 F.3d 329, 333 (6th Cir. 1993)). The statute of limitations begins to run on the date that the government's action accrues against the insolvent debtor's representative (*U.S. v. Renda*, 2011 WL 4474967, at *5 (E.D. Texas 2011)). The government's cause of action against the representative accrues when the acts that trigger the representative's liability occur; i.e., the voluntary assignment, act of bankruptcy or attachment of property (*U.S. v. Moriarty*, 8 F.3d at 333).

Context

Different government agencies have invoked the FPA fairly actively in recent years. Since the end of 2011, the Act has been cited in approximately 15 cases. Of these cases, the most common circumstances involved claims against insolvent government debtors arising from unpaid estate taxes. The common facts tended to involve an executor of an estate who distributed an estate's funds before paying debts owed to the federal government and consequently left the estate with insufficient funds to fully discharge its debt to the federal government.[3]

The second most common circumstances in which the government has invoked the FPA involve other kinds of taxes, such as income tax, employment tax, or gift tax. For example, in *U.S. Dept. of Justice v. Sperry*, No. 1:12-CV-0020-JMS, 2013WL 1768664 (S.D. Ind. Apr. 24, 2013), the owner of an insolvent company did not pay federal employment taxes, although he kept paying other creditors under the mistaken belief that he would be able to satisfy his government debts at a later time. The government invoked the FPA to seek the amount it alleged the company paid to other creditors while it was insolvent (*Id.* at *3).

Although the FPA has most often been invoked in tax cases, the government has also used the FPA in other circumstances recently. For instance, in *Burns v. Burns Iron & Metal Co. Inc.,* No. S-12-024 (Ohio Ct. App. May 17, 2013), the U.S. Environmental Protection Agency (EPA) filed a Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA) claim against Burns Iron & Metal Company.[4] During the course of the CERCLA action, the three shareholders of the company entered a stock redemption agreement whereby they sold almost all their stocks as a way to fund their own retirements (*Id.* at *1). When the EPA learned of this stock redemption agreement, it suspected that the shareholders were trying to divest the company of sufficient funds to pay for the cleanup. Consequently, the EPA pursued a potential claim under the FPA (*Id*).

The U.S. Department of Homeland Security, Customs, and Border Protection (Customs) has also invoked the FPA. In *U.S. v. Adaptive MicroSystems, LLC*, 914 F. Supp. 2d 1331 (Ct. Int'l Trade, 2013), Customs alleged that the defendant company had misclassified its imports under duty-free tariff and consequently owed several million dollars in unpaid dues. After the defendant company became subject to a receivership action, the government claimed priority under the FPA (*Id.* at 1335).

Another notable instance in which the government has invoked the FPA in recent years related to a breach of contract by a government contractor. In *U.S. v. Renda*, 709 F.3d 472 (5th Cir. 2013), the government obtained a judgment for breach of contract against an insolvent company. Before that decision was made final, the insolvent company transferred its assets to its unsecured creditors (*Id.* at 477). The Fifth Circuit held that the insolvent company was liable to the government under the FPA for the amount of assets it had transferred to its creditors (*Id.* at 487).

The U.S. Department of Labor has also pursued a claim under the FPA against an insolvent insurance company that owed money to a special fund established by the Longshore Act (*Solis v. Home Ins. Co.*, 848 F. Supp. 2d 91, 94 (D.N.H. 2012)).

In sum, although the most common circumstance in which the government pursues claims under the FPA involves delinquent taxes, the government has also employed the Act in many other circumstances in which an insolvent entity did not assign priority to its government debts.

What Constitutes a Claim

31 U.S.C. § 3701(b)(1) defines "claim" 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 by a person, organization, or entity other than a Federal Agency."[5] In practice, it is very difficult to put forward a precise definition of a claim within the meaning of the FPA, because courts have employed a very expansive definition of what a claim can be. However, it appears that as long as a debt to the federal government existed when the act of bankruptcy was committed, the government can pursue a claim under the FPA.

The Supreme Court has instructed lower courts to give the FPA "a liberal construction" (*Bramwell v. U.S. Fid. & Guar. Co.*, 269 U.S. 483, 487 (1926), *U.S. v. Coppola,* 85 F.3d 1015, 1020 (2d. Cir.1996)). Consequently, "[a]ll debtors to the United States, whatever their character, and by whatever mode bound, may be fairly included" within the statute (*Bramwell,* 269 U.S. at 487). Therefore, a claim is interpreted expansively, and "courts have applied the priority statue to claims of all types" (*United States v. Moore*, 423 U.S. 77, 80 (1975)).

For instance, for the purposes of what constitutes a claim, the Supreme Court has refused to draw a distinction between liquidated and unliquidated debts. In *Moore*, a contractor defaulted on a government contract prior to insolvency. The precise amount of the government's claim was not set until after the act of bankruptcy occurred. The defendant argued that debts that were unliquidated at the time of insolvency were not entitled to priority as claims under the Federal Priority Act.[6] The Supreme Court rejected this argument, making clear that *fixed but unliquidated debts still constituted a claim* for the purposes of the priority statute, noting that "the obligation here … was fixed and independent of 'events after insolvency'; only the precise amount of that obligation awaited future events" (*Moore*, 423 U.S. at 85).

A similar outcome was reached in *United States v. Johnson*, No. 2:11-CV-00087, 2013 WL 3924087 (D. Utah July 29, 2013). In that case, the representatives of an estate deferred payment of federal estate tax liability, opting to make the payment in 10 annual installments. The representatives then distributed the estate's remaining assets to the heirs, noting that the heirs would each bear an equal obligation to pay the estate tax as it became due (*Id.* at *2). At a later time, the heirs became insolvent, and the IRS invoked the FPA to collect the outstanding tax liability against the estate. The representatives of the estate argued that the government had no claim because, at the time that they had distributed the estate's assets, enough money existed to pay the government debt (*Id.* at *14). The court rejected this argument, reasoning that the representatives had accepted the risk that the heirs may fail to pay the tax. Consequently, the court held that the government had stated a claim (*Id.* at *16).

Courts have also held that the government had a claim within the meaning of the FPA even though its cause of action for recovery was barred by the statute of limitations[7], and that a defendant's tax liabilities were subject to the government's claim of priority even though they were contested and had not been formally assessed.[8]

In short, because the Act has been consistently interpreted expansively, it is difficult to delineate a threshold for when a claim may arise. Nonetheless, it may be that as long as a debt existed when the act of bankruptcy was committed, the government may have a claim of priority, regardless of whether the amount of the debt was precisely determined. The statutory language of 31 U.S.C. § 3701 is similarly broad.

Liability of Representatives of the Debtor

The FPA imposes liability upon the representatives of the person paying any part of a debt of the person before paying the federal government's claim (*see* 31 U.S.C. § 3713(b)):

> A representative of a person or an estate (except a trustee acting under title 11) paying any part of a debt of the person or estate before paying a claim of the Government is liable to the extent of the payment for unpaid claims of the Government.

The representative is liable to the extent of the "unauthorized" payment (*Id*).

Liability is not necessarily strict liability; rather, the representative needs to have knowledge of the federal government debt or notice of facts that would cause the representative to inquire as to the existence of the debt. "[I]t has long been held that in order to render a fiduciary liable … he must first be chargeable with knowledge or notice of the debt due to the United States, at a time when the estate had sufficient assets from which to pay this debt" (*In re Estate of Denman*, 270 S.W.3d 639, 644 (Tex. App.–San Antonio 2008) (internal citations and quotations omitted); *Bank of West v. C.I.R.*, 93 T.C. 462, 474 (Tax Ct. 1989)).

One case in the Eighth Circuit has stated that the liability of a representative is dependent on three things: (1) the personal representative distributed assets of the estate, (2) the distribution rendered the estate insolvent, and (3) the distribution took place after the personal representative had notice of the government's claim (*United States v. Estate of Kime*, 950 F. Supp. 950, 954 (D. Neb. 1996) (personal representative distributed all assets of estate to himself, knowing that the estate owed the government $140,000)). This case appears to make it a requirement (for imposition of personal liability) that the unauthorized transfer render the person or estate insolvent and not merely require that the person or estate be insolvent at the time of the unauthorized transfer. *See also U.S. v. Coppola*, 85 F.3d 1015 (2nd Cir. 1996) ("Accordingly, by the statute's express terms, liability is imposed on a representative of a debtor, including an executor of an estate, who pays a debt of the estate to another in derogation of the priority of debts owed to the United States, thereby rendering the estate insolvent."). *But see U.S. v. Estate of Dickerson*, 189 F. Supp. 2d 622 (W.D. Tex. 2001) (U.S. must show that executor distributed asset of estate, estate was insolvent, and executor had notice of debt owed to the government before the distribution; case references that transfer in violation of government's priority rendered estate insolvent, but does not make it a requirement for personal liability to attach). Because *Kime* is a decedent's estate-type case, it is possible that a court could decline to extend these three requirements for liability to directors and officers of an insolvent corporation.

When it is a corporation paying out its assets prior to satisfying its debts to the government, the potentially liable representatives are the corporation's officers and directors. *See Golden Acres*, 684 F. Supp. at 101-02 (finding that sole officers and directors of corporation were representatives of corporation and liable to the extent of the payment for unpaid claims of the government) and cases cited therein. A corporate officer and director may be presumed to know of corporate indebtedness (*In re Gottheiner*, 703 F.2d 1136, 1141 (9th Cir. 1983)).

Limitations

Although "claims" under the FPA are interpreted expansively, the term is not unlimited in scope. The government only has a claim if the debt owed to the U.S. government exists at the time of the act of bankruptcy. Debts that do not arise until after the act of bankruptcy have already occurred cannot be claims under the FPA.

This concept is illustrated in *In Re Metzger*, 709 F.2d 32 (9th Cir. 1983).[9] In *Metzger*, a lawyer performed legal services for his client in the form of criminal-defense representation. After the case was submitted, the client assigned his interest in a shipping vessel to the lawyer (*Id.* at 33). Several weeks later, the trial judge sentenced the client to a prison sentence and ordered the client to pay the U.S. government a fine in the amount of $45,000. The United States attempted to collect the $45,000 by asserting priority in the shipping vessel the client had assigned to the lawyer (*Id*). The Ninth Circuit concluded that at the time of the assignment of the vessel, the client was not indebted to the United States. Rather, the client only became indebted at the time of sentencing, which occurred after the assignment of property (*Id.* at 34). Because the debt owed to the United States did not exist until after the act of bankruptcy, the United States could not state a claim under the FPA (*Id*). In short, debts not currently in existence, but which may arise in the future contingent on other events, cannot be claims.

Another limitation is that the FPA does not apply to cases under Title 11. This is an express limitation, provided for in 31

U.S.C. § 3713 (a)(2). Courts have explained that the bankruptcy code has restricted the FPA's reach. For instance, in *In Re Gottheiner*, 703 F.2d 1136, 1137 n.2 (9th Cir. 1983), the court clarified that amendments to the federal priority statute had "eliminated the government's priority rights in bankruptcy cases filed after October 1, 1979."[10]

Other Defenses

The FPA is very broad, and has few limitations other than the failure to meet the statute's requirements. But even though the language of the FPA is simple and seemingly absolute, the cases suggests that there are exceptions to its coverage. S*ee Straus v. U.S.*, No. 97 C 8187, 1998 WL 748344, at *3 (N.D. Ill. Oct. 20, 1998). Another, more specific statute, such as the Tax Lien Act of 1966, can create an exception to the FPA (*Id*). As another exception, the federal government may not trump another party's lien where the party has gained possession or title to the debtor's personal property (Id. *4). The federal government may not trump another party's lien where the party has gained possession or title to the debtor's personal property (*Id*. *4).

Another defense that can arise in very narrow circumstances is reverse preemption. Reverse preemption can occur when another federal statute requires that the states retain primacy in a given area of law absent an express intention of congress. For instance, the McCarran-Ferguson Act specifically requires that the states retain primacy in the area of insurance law absent an express intention of Congress. Consequently, in *Solis v. Home Ins. Co.*, 848 F. Supp. 2d 91, (D.N.H. 2012), a New Hampshire insurance company was permitted to pay other creditors before the federal government in accordance with a New Hampshire insurance law.

Also, because the intent of the FPA is to ensure that the government is paid first, it is not a defense that the transferee of the debtor's funds uses the funds to pay off the transferor's debts. *See U.S. v. 58th Street Plaza Theatre Inc.*, 287 F. Supp. 475, 496-97 (S.D.N.Y. 1968).

Health Care Cases

Some cases show that the Act is periodically applied in healthcare settings. For example, in *U.S. v. Bridle Path Enters Inc.*, 2001 WL 1688911 (D. Ma. 2001), the defendants owned Bridle Path, a health-care corporation that acted as a medical provider. In this role, Bridle Path submitted claims for Medicare reimbursement to its fiscal intermediary, which then made payments to Bridle Path based on cost estimates (*Id.* at *1). These payments were then subjected to later adjustment after the reasonable cost of the claims was determined (*Id*). After an audit, it was determined that Bridle Path had been overpaid by over $200,000 and was required to repay its Medicare debt (*Id*). During the period of repayment, the company became insolvent, as its liabilities exceeded its assets. Bridle Path ceased making Medicare repayments and wrote numerous checks to several entities out of its operating account (*Id.* at *2). These checks were written to both private creditors and to the corporation owners themselves. The government claimed that Bridle Path's owners had violated the FPA by not paying their government debts first and were personally liable for the Medicare debt at the time the insolvent corporation assigned property to themselves and others. The district court agreed, and Bridle Path's representatives were held liable (*Id.* at *4).

In *In re Gottheiner*, 703 F.2d 1136 (9th Cir. 1983), a medical doctor formed a corporation called Coordinated Health Services. The doctor was the sole shareholder of this corporation. The corporation occasionally submitted statements to the government's fiscal intermediary, in a process similar to that described in *Bridle Path* above (*Id.* at 1138). Although the corporation soon accrued debts that exceeded its assets, the doctor directed the company to make several loans and payments to himself and other corporations in which he owned shares (*Id*). The government claimed that these payments violated the FPA and argued that the corporation was indebted to the United States for the amount of the cash advances the corporation had received from the government insurer and not repaid (*Id.* at 1138-39). The District Court found that the corporation had been insolvent and owed a government debt at the time it assigned its assets elsewhere, and it found the doctor personally liable for this debt (*Id.* at 1138).[11]

Lastly, in *Garcia v. Island Program Designer Inc.*, 875 F. Supp. 940 (D.P.R. 1994), the defendant was a health service organization under Puerto Rico law. The defendant eventually became insolvent, and a court ordered its assets liquidated (*Id.* at 941). The U.S. Internal Revenue Service intervened in the state liquidation proceedings and removed the case to federal district court, claiming priority under the FPA *(Id*). In district court, the United States was granted summary judgment (*Id.* at 947). [12]

Although "claims" under the FPA are interpreted expansively, the term is not unlimited in scope. The government only has a claim if the debt owed to the U.S. government exists at the time of the act of bankruptcy. Debts that do not arise until after the act of bankruptcy have already occurred cannot be claims under the FPA.

Conclusion

This statute is not widely known, and yet it can have immense importance for insolvent entities. The liberal construction that courts give the FPA gives it a fairly broad application. When government debtors become insolvent and later assign property after the act of bankruptcy, the personal representative of the debtor can be held personally liable. Further, this liability attaches even if knowledge of the government claim was only constructive. And though there are well-established limitations and defenses to the Act, they are few in number. While the Act is most often invoked in tax and estate cases, it has also been applied in a wide variety of other contexts. Given the Act's far reach, the potential for personal liability, and its liberal construction and application, it is important that insolvent entities be aware of this Act's existence and scope. ☉

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Endnotes

[1]This article consists of updated research on the Federal Priority Act (FPA), 31 U.S.C. § 3713, focusing primarily on cases since the end of 2011.

[2]In one case, the court set the elements out as follows: "An individual violates the Federal Priority Statute if: (1) he is insolvent, (2) he is indebted to the federal government, and (3) he makes a voluntary payment to another person before fully paying the government debt." *U.S. v. David*, 1995 WL 57502, at *2 (E.D. Pa. 1995).

[3]Of the 15 cases that discussed claims brought under the FPA since the end of 2011, six of these cases related to unpaid estate taxes. *See, e.g., United States v. Whisenhunt*, No. 3:12-CV-0614-B, 2014 WL 1226177 (N.D. Tex. Mar. 25, 2014), *United States v. Anderson*, No. 2:13-CV-93-FTM-38UAM, 2013 WL 3816733 (M.D. Fla. July 22, 2013). Furthermore, three other cases from the last three years related to income or employment taxes. In other words, about 60 percent of the recent cases involved taxes. In any case, it is evident that tax delinquency is the most active area in which the government currently pursues claims under the FPA.

[4]*Burns* was a case about two parties seeking indemnity for losses incurred after entering a settlement with the EPA. The court does not engage in a legal discussion regarding the FPA. However, the case is significant for our purposes because its factual background makes clear that the federal government considers the FPA as a potential strategy in a variety of contexts.

[5]31 U.S.C. § 3701(b)(1) goes on to specify that a claim can include, without limitation, any of the following:

- Funds owed on account of loans made, insured, or guaranteed by the government, including any deficiency or any difference between the price obtained by the government in the sale of a property and the amount owed to the government on a mortgage on the property.
- Expenditures of nonappropriated funds, including actual and administrative costs related to shoplifting, theft detection, and theft prevention.
- Over-payments, including payments disallowed by audits performed by the inspector general of the agency administering the program.
- Any amount the United States is authorized by statute to collect for the benefit of any person.
- The unpaid share of any nonfederal partner in a program involving a federal payment and a matching, or cost-sharing, payment by the nonfederal partner.
- Any fines or penalties assessed by an agency.
- Other amounts of money or property owed to the government.

[6]This case involved an earlier but substantively indistinguishable version of the FPA.

[7]*United States v. Moriarty*, 8 F.3d 329, 334 (6th Cir. 1993).

[8]*Viles v. C.I.R.*, 223 F.2d 376, 380 (6th Cir. 1956).

[9]The same rationale is also used in *Cerilli v. Newport Offshore Ltd.*, 624 A.2d 835, 838 (R.I. 1993), *Guillermety v. Sec'y of Educ. of U.S.*, 241 F. Supp. 2d 727, 733 (E.D. Mich. 2002).

[10]*See also Davis v. Pringle*, 268 U.S. 315, 317-18 (U.S. 1925) (explaining that claims due to the United States are not entitled to priority under the Bankruptcy Act of 1898), *U.S. v. Birmingham Trust & Sav. Co.,* 258 F. 562, 563 (5th Cir. 1919) (noting that the right of the United States to claim priority under an earlier version of the FPA was "unquestionably modified and restricted" by the bankruptcy act), *United States v. Estate of Romani*, 523 U.S. 517, 531 (U.S. 1998) ("The Bankruptcy Act of 1898 … subordinated the priority of the Federal Government's claims … to certain other kinds of debts. This Court resolved the tension between the new bankruptcy provisions and the priority statute by applying the former and thus treating the Government like any other general creditor."). These cases dealt with an earlier version of the FPA and an earlier bankruptcy act. When the FPA was amended in 1982, these bankruptcy restrictions were expressly codified into the Act.

[11]This case's appeal in the Ninth Circuit focused primarily on the defendant's grounds for appeal, including collateral estoppel. However, a discussion of the district court's holdings regarding the FPA's application is included.

[12]The facts of this case are minimal. The bulk of the opinion discusses issues of preemption, eventually holding that the FPA was not preempted by other local Puerto Rico laws. The nuanced facts of this case are not discussed in the opinion. However, it is clear that the United States invoked the FPA successfully against a health provider.