

Federal Debt Priority Statute: A Little-known Law with Serious Consequences, The

Stosberg, Andrew D

Toxins-Are-Us

The Federal Debt Priority Statute² is a largely unknown compensation statute that may give environmental agencies leverage in negotiations with insolvent companies.³ The Priority Statute requires that an insolvent entity pay debts to the United States first before distributing assets to other creditors. Under the statute, a representative of the debtor that pays any part of a debt to another creditor before satisfying an obligation to the United States becomes personally liable to the extent of the unpaid government claim.⁴ Representatives of a debtor include attorneys and corporate officers, but not a trustee in a bankruptcy proceeding.

Priority statutes originated in England, where the king held preferred status in the collection of public moneys. This preference was motivated by public policy to assure adequate revenue to sustain public burdens.⁵ Originally enacted in 1797, the Priority Statute was described as "[a]n Act to provide more effectually for the Settlement of Accounts between the United States, and receivers of public money."⁶ Despite the evolution of most statutes over time, the Priority Statute has remained largely unaltered.

Applicability of the Statute

Three criteria must exist for the Priority Statute to apply. First, the debtor must be insolvent when it preferred another creditor over the United States. second, the debtor must do one of the following:

1. make a voluntary assignment of property without sufficient property to pay all debts;
2. suffer an attachment of its property; or
3. commit an act of bankruptcy.

Third, the debtor must not have filed a bankruptcy petition under federal law.

The Teeth of the Priority Statute

The Priority Statute requires that a debtor fitting the statute pay any debts to the government before nongovernment debts. The Priority Statute gets its teeth by implicating the representative of the debtor.⁷ A representative of a debtor that falls within the scope of the Priority Statute faces personal liability to the extent of the unpaid claims.

Representatives may include a bankruptcy attorney, but many bankruptcy attorneys are unfamiliar with the Priority Statute because both the debtor and its attorney are shielded from the Priority Statute when they are involved in a federal bankruptcy proceeding.⁸ The crucial mistake to avoid is the distribution of an estate under voluntary assignment for the benefit of creditors or similar nonfederal process while the debtor is insolvent, without initially paying debts to the United States in full.

Acts of Bankruptcy

To avoid the perils of personal liability under the Priority Statute, attorneys must understand when the statute applies. The first and third prerequisites under the statute are straightforward. The second prerequisite, dealing with an "act of

bankruptcy," is more challenging.

The "act of bankruptcy" element of the statute is a tricky condition. Prior to 1978, a creditor could only file an involuntary petition against a debtor if the debtor engaged in an act of bankruptcy. As of 1976, the Bankruptcy Act defined "acts of bankruptcy" to include a debtor:

1. attempting to hinder or defraud creditors;
2. making a preferential transfer;
3. while insolvent, suffering or permitting any creditor to obtain a lien upon any of debtor's property through legal proceedings and not having vacated or discharged such lien within 30 days from the date thereof, or at least five days before the date of sale or disposition of such property;
4. making a general assignment for the benefit of creditors;
5. appointment of a receiver to take charge of debtor's property; or
6. admitting in writing the inability to pay debts and the willingness to be adjudged a bankrupt.

11 U.S.C. Â§21(a) (1976) (repealed 1978).

Though acts of bankruptcy are no longer relevant under title 11, they remain relevant under the Priority Statute.⁹ Of particular importance to bankruptcy attorneys is the appointment of a receiver, which would constitute an act of bankruptcy triggering the statute's personal liability provision.¹⁰

Not only does the appointment of a receiver qualify as an act of bankruptcy, the receiver is a representative that runs the risk of personal liability. In *US. v. Crocker*,¹¹ the Ninth Circuit recognized the receiver's obligation to give federal debts priority: "[A] receiver appointed by a federal or state court who takes possession and control of the assets of an insolvent debtor must first satisfy obligations due the United States."¹²

The following year, the U.S. Supreme Court in *King v. US*,¹³ also determined that the Priority Statute imposed personal liability on a receiver. The Supreme Court found that the purpose of the Priority Statute "is to make those into whose hand control and possession of the debtor's assets are placed, responsible for seeing that the Government's priority is paid."¹⁴ A receiver appointed to a debtor falling under the Priority Statute must tread carefully to avoid any issues of personal liability. These potentially serious consequences are not triggered in every instance, however.

Knowledge

A literal reading of the Priority Statute seemingly imposes strict liability on a representative when it makes a distribution that leaves the estate with insufficient funds to address a debt owed the United States. "It is this knowing disregard of the debts due to the United States that imposes liability on the extent of the value of the assets distributed after knowledge of the debt was obtained."¹⁵

Courts do not adhere to such a strict interpretation, however. In order to render a representative personally 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."¹⁶ The knowledge requirement may be satisfied by either actual knowledge of the liability or notice of such facts as would lead a reasonably prudent person to inquire into the existence of the unpaid claim of the United States.¹⁷

Priority Statute and Environmental Issues

The Priority Statute represents a different way for the federal government to address environmental issues. The Comprehensive Environmental Response, Compensation Liability Act (CERCLA) authorizes the federal government to clean up environmentally impaired property and recover the response costs from potential responsible persons.¹⁸ One common goal of CERCLA and the Priority Statute is to acquire funds on the government's behalf from private entities. Consequently, when the EPA incurs costs responding to environmental damages and the debtor is insolvent, the EPA may use the Priority Statute as leverage to gain first priority status among unsecured creditors.

Should the federal government satisfy the three prerequisites of the Priority Statute, it should recover clean-up costs under CERCLA before other unsecured claims are paid. The Priority Statute is typically consolidated with actions under environmental statutes such as CERCLA and the Resource Conservation and Recovery Act to ensure the government has priority for recovery of clean-up costs of polluted sites." As a super-priority unsecured debt, the government may not fully recover the clean-up costs from the debtor, but no other unsecured creditors will further diminish the debtor's ability to pay its debt to the United States.

Conclusion

The Priority Statute, though largely unknown, is one of the oldest statutes in the U.S. Code. The ability to take ahead of other general unsecured, nongovernment creditors, combined with the threat of personal liability against the debtor's representative, make this statute a potentially powerful tool of the federal government. The government has used the Priority Statute as a means of obtaining clean-up costs for polluted sites, and clearly the statute may play a strong role in environmental litigation. It is likely this statute will affect other governmental collection efforts if it becomes more widely known and interpreted.

¹ The authors acknowledge the assistance of Francis D. McWilliams in preparation of this article.

¹ The Priority Statute, 31 U.S.C. Â§3713, states:

(a)(1) 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;

(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) This subsection does not apply to a case under title 11,

(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.

In a 2005 Massachusetts District Court case, neither counsel for the government nor the defendant knew of the Priority Statute, even though it applied to the case. They were eventually informed of the statute by the Department of Justice. *US v. Mountzoures*, 376 F. Supp. 2d 13, 16 (D. Mass. 2005). Counsel for the government, the Bureau of Prisons, then brought suit under the Priority Statute against the debtors' bankruptcy attorney for distributing debtors' assets without satisfying the government's claim. The court found the Priority Statute did not apply as the Bureau of Prisons was not a creditor of

the debtors, and therefore, the attorney could not be held personally liable under the statute. *Id.* at 21.

4 31 U.S.C. Â§3713(b).

5 *U.S. v. State Bank of N.C.*, 31 U.S. 29, 35 (1832).

6 *U.S. v. Fisher*, 6 U.S. 358, 398 (1805).

7 31 U.S.C. Â§3713(b).

8 31 U.S.C. Â§3713.

9 *F.T.C. v. Crittenden*, 823 F.Supp. 705, 707 (C.D. Cal. 1993); *Carter v. Carter*, 681 F. Supp. 323, 326 (E.D. Va. 1988).

10 *U.S. v. Emory*, 314 U.S. 423, 426 (1941).

11 *U.S. v. Cracker*, 313 F.2d 946,948 (9th Cir. 1963).

12 *Id.*

13 *King v. U.S.*, 379 U.S. 329, 337 (1964).

14 *Id.*

15 *Leigh v. Comm'r.*, 72 T.C. 1105,1109-10 (1979).

16 *Id.* at 1109.

17 See *Crocker* at 948-949 (knowledge implies a choice was made).

18 42 U.S.C. Â§9601.

19 *U.S. v. Hercules Inc.*, 961 F 2d 796. 798 (8th Cir. 1992); *US. v. Vertac Chemical Corp.*, 756 F. Supp. 1215, 1216 (E.D. Ark. 1991).

Contributing Editor:

Andrew D. Stosberg

Greenebaum Doll & McDonald PLLC

Louisville, Ky.

ads@gdm.com

About the Authors

Greg Schaaf is a member of the Bankruptcy and Workout Team in the Lexington, Ky., office of Greenebaum, Doll & McDonald, PLLC. Andrew Stosberg is a member in the Bankruptcy Department at Greenebaum Doll & McDonald PLLC in Louisville, Ky.

Copyright American Bankruptcy Institute Sep 2008

Provided by ProQuest Information and Learning Company. All rights Reserved