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Feature

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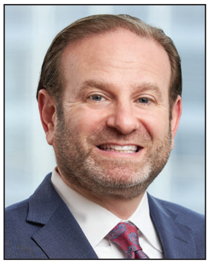
Fiduciaries Must "CARE"

Personal Liability for PPP Loans Under Federal Priority Statute



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Any person in control of an insolvent debtor's assets making distributions to unsecured creditors prior to satisfying a Paycheck Protection Program (PPP) loan might face personal liability for that debt under the federal priority statute.[1] Under the Coronavirus Aid, Relief, and Economic Security (CARES) Act, the U.S. Small Business Administration (SBA) guaranteed PPP loans made by private lenders to provide a financial lifeline to businesses during the COVID-19 pandemic. The priority statute ensures the superpriority of the SBA's guaranty claims against insolvent debtors upon any "act of bankruptcy" other than the filing of a case under the Bankruptcy Code.

If the loans are not forgiven, then officers, directors, receivers, assignees and other fiduciaries that do not prioritize PPP loans may face personal liability to the federal government for violating the priority statute. In order to avoid personal liability, fiduciaries must understand the applicability of the priority statute to loans guaranteed by the federal government.

SBA's Role as Guarantor of PPP Loans

Congress established the PPP though the CARES Act by expanding the traditional SBA 7(a) loan program to provide forgivable unsecured loans to help businesses retain employees during the pandemic. The SBA does not make PPP loans directly to borrowers; rather, private lenders make the loans, which are guaranteed by the SBA. Borrowers are eligible for PPP loan forgiveness if (1) the borrower maintains its employee and compensation levels; (2) the proceeds are used on certain eligible expenses; and (3) at least 60 percent of the proceeds are spent on payroll. The lender funds the PPP loan with the expectation that the SBA will pay the portion of the loan that is forgiven and any portion of the loan that is not paid by the borrower.

However, if the PPP loan is not forgiven and the borrower defaults, the lender will request that the SBA honor its guarantee. If the lender complied with its obligations under the program, the SBA will then "purchase" the loan and pay off the lender. At that point, the SBA becomes a creditor of the borrower and the priority statute comes into play.

Government's Claims Must Be Paid First

The priority statute has been around since 1797 without significant modification.[2] Its purpose is to secure adequate revenue for the government, and courts liberally construe the statute in order to achieve that objective.[3] The priority statute provides that a claim of the federal government shall be paid first when (1) a debt is due to the federal government; (2) by a debtor that is insolvent; and (3) the debtor either "makes a voluntary assignment of property," an absent debtor has its property attached, or "an act of bankruptcy is committed."[4] A federal claim entitled to priority must be paid before all other claims regardless of state law.[5]

The party contesting the government's priority bears the burden of demonstrating that the priority statute is inapplicable.[6] As discussed herein, in order to avoid personal liability, fiduciaries should determine whether (1) they are covered by the statute; (2) the government's claim falls within the statute's scope; and (3) the government's priority attached.

1 31 U.S.C. § 3713.

2 *U.S. v. Emory*, 314 U.S. 423, 428 (1941). Thus, authorities cited in this article may cite to § 3713 or earlier codifications of the statute.
3 *Id.* at 425.
4 31 U.S.C. § 3713(a)(1)(A).
5 *U.S. v. Oklahoma*, 261 U.S. 253, 260 (1923).
6 *Bramwell v. U.S. Fidelity & Gur. Co.*, 269 U.S. 483, 487 (1926).

Representatives Covered

The priority statute applies to all fiduciaries in control of an entity's assets. The statute provides that any "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."[7] This provision "make[s] those into whose hands control and possession of the debtor's assets are placed, responsible for seeing that the Government's priority is paid."[8]

Given that goal, neither the representative's title nor the mode of appointment is relevant. Rather, the test to determine whether the representative falls within the scope of the priority statute is determined by the degree of control that the fiduciary has over how the debtor's assets in his/her possession are allocated among creditors.[9] Under this analysis, officers, directors, managers, receivers, assignees, disbursing agents, executors and administrators are all fiduciaries that may fall within the scope of the statute.[10]

Federal Claims Covered

While most commonly applied to tax claims, the priority statute applies to substantially all claims of the federal government.[11] It defines the term "claim" or "debt" 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 another Federal agency."[12] This definition is followed by a nonexhaustive list that includes "funds owed on account of loans made, insured, or guaranteed by the Government," and ends with the catch-all "other amounts of money or property owed to the federal government.[13] The term "claim" has also been broadly interpreted to include any "right to payment" whether or not reduced to judgment or liquidated.[14] Loans made in participation with a lender or made by a lender and subsequently assigned to a federal agency all fall within the purview of the statute.[15] Thus, how a government agency such as the SBA acquires its claim is irrelevant.

When the Government's Priority Attaches

The federal government's priority attaches when an insolvent debtor is divested of its assets in one of the methods specified in the priority statute (*i.e.*, makes an assignment of its property, has its property attached or commits an "act of bankruptcy").[16] Although the phrase "act of bankruptcy" is not defined in the statute, it does not include the filing of a case under the Bankruptcy Code.[17] Rather, courts have historically looked to the definition of "act of bankruptcy" from the repealed Bankruptcy Act to construe the term.[18]

Under the Bankruptcy Act, "acts of bankruptcy" include, among other things, an assignment for the benefit of creditors, the appointment of a receiver, and the making of preferential or fraudulent transfers.[19] For example, corporate officers have been held liable for the government's debt after they made preferential or fraudulent transfers of an insolvent company's assets.[20] Unless an exception applies, the government's priority claim becomes absolute and unconditional upon the "act of bankruptcy."[21]

Limited Exceptions to Liability

There are a few judicially made exceptions to the priority statute. First, the government's claim must "exist" at the time the debtor is divested of its property. A debt assigned to the government *after* the debtor is divested of its property is not entitled to priority because the rights of creditors are "fixed" upon the "act of bankruptcy."[22] Put another way, the government must have legal title to or beneficial ownership of the debt before the debtor is divested of its property.[23] Thus, the SBA is not entitled to priority on account of a loan guaranty if the SBA obtains an assignment of the indebtedness from the original lender after the borrower commits an act of bankruptcy.[24] Consequently, *when* the government obtains ownership of the debt is critical to determining whether the claim is entitled to priority.

Second, the government's priority is subject to a "specific and perfected lien" held by a secured creditor.[25] This exception is more complicated then it appears, however. In order for a lien to be sufficiently specific and perfected, "title to or possession of the debtor's property must have been conveyed to the lienor before the right of preference accrued to the United States."[26] The basis for this exception is that the government "has no claim against property no longer in the possession of the debtor."[27]

The continued vitality of this requirement in the context of federal lending programs is questionable in light of the U.S. Supreme Court's decision in *Kimbell Foods*. In that case, the Court held that the "first in time, first in right" priority-lien analysis applies to federal government loans involving *solvent* debtors. The Court determined that government lending agencies such as the SBA are entitled to the same priority as private lenders under nondiscriminatory state laws, absent a congressional directive to the contrary.[28] Subsequently, at least one court has extended the *Kimbell* analysis to government loans involving *insolvent* debtors under the priority statute.[29] Thus, secured creditors that perfected their liens under state law prior to the government's priority attaching might be entitled to payment notwithstanding the priority statute. As the Supreme Court noted, however, whether the priority statute applies to "antecedent perfected liens has never

7 31 U.S.C. § 3713(b).
8 *King v. U.S.*, 379 U.S. 329, 337 (1964).
9 *Id.*
10 *Id.*; *Lakeshore Apts. Inc. v. U.S.*, 351 F.2d 349 (9th Cir. 1965); *U.S. v. Golden Acres Inc.*, 684 F. Supp. 96 (D. Del. 1988); *U.S. v. Moore*, 423 U.S. 77 (1975); *Emory*, 314 U.S. at 426; *U.S. v. Whitney*, 654 F.2d 607 (9th Cir. 1981).
11 *Commonwealth of Mass. v. U.S.*, 333 U.S. 611, 625 n.24 (1948).
12 31 U.S.C. § 3701(b)(1).
13 *Id.*
14 *U.S. v. Moriarity*, 8 F.3d 329, 334 (6th Cir. 1993); *Moore*, 423 U.S. at 78.
15 *SBA v. McClellan*, 364 U.S. 446 (1960); *Lakeshore*, 351 F.2d at 353.
16 *Guillermety v. Secretary of Edu.*, 241 F. Supp. 2d 727, 733 (E.D. Mich. 2002).
17 31 U.S.C. § 3713(a)(2).
18 *Oklahoma*, 261 U.S. at 262; *Moore*, 423 U.S. at 83-84.
19 Bankruptcy Act § 3 (1898).
20 *Golden*, 684 F. Supp. at 101.
21 *Massachusetts*, 333 U.S. at 625.
22 *U.S. v. Marxen*, 307 U.S. 200, 208 (1939).
23 *U.S. v. Brocato*, 403 F.2d 105, 109-10 (5th Cir. 1968).
24 *Id.*
25 *U.S. v. Estate of Romani*, 523 U.S. 517, 529 (1998).
26 *Straus v. U.S.*, 196 F.3d 862 (7th Cir. 1999).
27 *U.S. v. Gilbert Assocs.*, 345 U.S. 361, 366 (1953).
28 *U.S. v. Kimbell Foods Inc.*, 440 U.S. 715, 740 (1979).
29 *U.S. v. S.K.A. Assoc's Inc.*, 600 F.2d 513 (5th Cir. 1979).

been answered definitively."[30] Accordingly, a fiduciary should not assume that all prior perfected liens trump the government's priority.

Third, courts have found implied exceptions to the priority statute where its application would be plainly inconsistent with another later enacted federal statute.[31] In *Romani*, the Supreme Court analyzed whether the Tax Lien Act or the priority statute determined whether the government's tax claim had priority over a judgment creditor's lien. The Tax Lien Act grants a judgment lien creditor priority over a federal tax lien if the notice of the tax lien is not filed prior to the perfection of the judgment lien.

The Court explained that the Tax Lien Act was a later, more specific and comprehensive statute reflecting Congress's clear intent to protect secured creditors from the enforcement of secret tax liens. Therefore, the Tax Lien Act controlled and the lienholder's prior perfected lien was entitled to priority over the tax claim.[32] However, the Supreme Court has made it clear that any implied exceptions are limited because "[o]nly the plainest inconsistency would warrant our finding an implied exception to the operation of so clear a command as that of [the priority statute]."[33] On that basis, the Court rejected the argument that the priority statute should not apply to SBA loans on the theory that granting priority to the government would make it harder for small businesses to obtain credit and thus conflict with the purpose of the Small Business Act.[34]

Fourth, the government's claims under the priority statute are subordinate to the reasonable expenses, including legal fees, incurred by a fiduciary in administering and preserving an insolvent estate. Those administrative expenses are entitled to priority based on the equitable principle that creditors should bear the expense of proceedings undertaken for their benefit.[35]

Personal Liability of Fiduciaries

Congress gave the priority statute teeth by imposing personal liability on a fiduciaries that pay other creditors before paying the priority claims of the federal government.[36] To avoid unfairness, however, courts have read into the statute the requirement that the fiduciary must have actual or inquiry notice of the government's claim before personal liability will be imposed.[37] The federal government need not file an appearance or a claim in any proceedings for personal liability to attach.[38] Any funds paid by a fiduciary in derogation of the priority statute might also be recovered from the recipients.[39]

Courts have held fiduciaries personally responsible even when the distributions were made as a result of erroneous advice of counsel or made pursuant to a court order.[40] In *King*, the government brought a claim under the priority statute against the probate estate of a disbursing agent that made distributions under a confirmed chapter XI plan under the Bankruptcy Act.[41] Despite having knowledge of the government's contingent and unliquidated claim, the disbursing agent paid out estate funds to nongovernmental creditors with the bankruptcy court's approval. This left insufficient funds to pay the government's claim when it was finally liquidated several years later. The Supreme Court held that the disbursing agent was personally liable under the priority statute because he knew that the government had a contingent and unliquidated claim at the time the funds under his control were paid to the nongovernmental creditors.

Navigating the Priority Statute with PPP Loans

Consider a hypothetical where an insolvent company that is not eligible for PPP loan forgiveness transfers its assets to an assignee for the benefit of creditors. Immediately prior to the assignment, the company's president pays off an unsecured loan to a shareholder and the claim of a vendor with a personal guaranty from the president. The president is a fiduciary within the scope of the priority statute and knew about the PPP loan when he satisfied the shareholder's loan and the vendor's claim. The payments are likely preferential and constitute an act of bankruptcy triggering the priority statute. Ultimately, the president's liability may come down to whether the SBA acquired the PPP loan from the lender prior to the preferential transfers. If the president is liable, the government may also recover the preferential payments directly from the shareholder and the vendor.

In addition, the assignee falls within the scope of the statute since it will determine how the company's assets will be disbursed to creditors. The assignee must not blithely rely on the distribution schemes set forth under the Bankruptcy Code or state law when making distributions. There are a number of steps that a diligent assignee should take to avoid the risk of personal liability to the federal government.

First, the assignee should communicate with the SBA because the SBA's failure to participate in the assignment will not insulate the assignee from liability. The assignee should confirm when the SBA assumed the PPP loan and whether the SBA asserts a priority claim over secured and unsecured debt. The assignee may also request that the SBA subordinate its claim. Any subordination would be an internal policy decision at the SBA, which, unlike the Internal Revenue Service, has no formal administrative process for evaluating such requests.[42]

Second, even if the SBA does not assert priority over lienholders, the assignee must confirm that any lienholders are perfected under applicable state law. If not, the SBA may take the position that the assignee distributed funds to an unsecured creditor in violation of the priority statute.

Third, if the SBA's claim is disputed, distributions should not be made until there is a final order, no longer subject

30 *Romani*, 523 U.S. at 529.
31 *Id.* at 528-34.
32 *Id.*
33 *Id.*
34 *McClellan*, 364 U.S. at 453.
35 *Abrams v. U.S.*, 274 F.2d 8, 12 (8th Cir. 1960).
36 31 U.S.C. § 3713(b); *Moore*, 423 U.S. at 80.
37 *U.S. v. Renda*, 709 F.3d 472, 480 (5th Cir. 2013).
38 *U.S. v. Boots*, 675 F. Supp. 550, 552 (E.D. Mo. 1987).
39 *Indian Motorcycle Mfg. Inc.*, 2006 WL 2471767, at *8 (D. Colo. July 28, 2006).
40 *Renda*, 709 F.3d at 484; *Nw. Jobbers Credit Bureau v. Comm'r*, 1 T.C. 863 (1943); *Farmer's Co-Op.*, 200 Iowa 1160 (1925).
41 *King*, 379 U.S. at 330-37.
42 *See* Dep't of Justice Tax. Div. Dir. No. 137.

to review, that determines the amount and priority of its claim. In any litigation, the assignee could argue that the priority statute is plainly inconsistent with purposes of the later enacted CARES Act (*i.e.*, to use the PPP loan proceeds to pay employees during the pandemic) and therefore no priority exists over unpaid wages or other PPP eligible claims. Where the SBA's claim is less than the total amount to be distributed, the assignee has the option of holding back a reserve in the amount of the SBA's asserted claim until the matter is fully litigated.[43]

Conclusion

Any decision to make distributions to creditors without first paying the SBA in full should only be taken after evaluating the applicability of the federal priority statute. Failure to take that precautionary step could result in severe adverse consequences for the fiduciary. abi

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43 *S.E.C. v. Credit Bancorp Ltd.*, 297 F.2d 127, 140 (2d Cir. 2002).