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Federal Priority Statute Gives United States Nontax Priority in Chapter X Corporate Reorganizations—*United States v. Anderson**

In a proceeding under Chapter X of the Bankruptcy Act[1] for the reorganization of an insolvent corporation, the United States claimed first priority for nontax debts[2] under the federal priority statute, Revised Statutes § 3466.[3] The trustee of the corporation contested the claim to priority on the ground that section 199 of Chapter X,[4] which in effect provides the United States in Chapter X proceedings with priority only for tax and customs claims, is exclusive and therefore R.S. § 3466 does not apply. The district court denied the claim to priority. On appeal to the Court of Appeals for the Fifth Circuit, *held*, reversed, one judge dissenting. R.S. § 3466 is operative to give all debts due to the United States priority in a Chapter X corporate reorganization proceeding.

Under English common law the Crown enjoyed an absolute priority over all other creditors of an insolvent debtor. Attributed to royal prerogative, this deference to the Crown was based on the necessity of preserving government revenue.[5] The Supreme Court has held this sovereign priority to be superseded in this country by a statutory grant of federal priority; consequently, the United States must look solely to statutes when advancing its claims.[6] How-

* 334 F.2d 111 (5th Cir.), *cert. denied*, 379 U.S. 879 (1964).

1. 52 Stat. 883 (1938), 11 U.S.C. §§ 501-676 (1958).

2. The claims, amounting to $904,634,124, were filed by the Maritime Administration, Small Business Administration, Departments of the Army and Navy, and the Post Office Department.

3. REV. STAT. § 3466 (1875), 31 U.S.C. § 191 (1954) (hereinafter cited as R.S. § 3466) reads in full: "Whenever any person indebted to the United States is insolvent, or whenever the estate of any deceased debtor, in the hands of the executors or administrators, is insufficient to pay all the debts due from the deceased, the debts due to the United States shall be first satisfied; and the priority established shall extend as well to cases in which a debtor, not having sufficient property to pay all his debts, makes a voluntary assignment thereof, or in which the estate and effects of an absconding, concealed, or absent debtor are attached by process of law, as to cases in which an act of bankruptcy is committed."

4. 52 Stat. 893 (1938), 11 U.S.C. § 599 (1958), reads in part: "If, in any proceeding under this chapter, the United States is a secured or unsecured creditor on claims for taxes or customs duties, . . . no plan which does not provide for the payment thereof shall be confirmed by the judge except upon the acceptance of a lesser amount by the Secretary of the Treasury. . . ." The priority thus conferred by § 199 "is superior to all other claims against the estate, even to existing and perfected liens which might otherwise be prior." 2 MOORE & OGLEBAY, CORPORATE REORGANIZATION § 9.17 (1948). *But see* FINLETTER, BANKRUPTCY REORGANIZATION 391 (1939).

5. See Small Business Administration v. McClellan, 364 U.S. 446 (1960); United States v. Oklahoma, 261 U.S. 253 (1923); United States v. Bank of N.C., 31 U.S. 29 (1832); Logan, *Priorities and Lien Preferences Accorded Federal and State Claims in Corporate Reorganizations*, 16 TAXES 201 (1938).

6. See United States v. Oklahoma, *supra* note 5; United States v. Bank of N.C., *supra* note 5.

ever, before the United States can utilize R.S. § 3466, the debtor must be insolvent. The standard for determining insolvency under R.S. § 3466 is the balance sheet test: whether the corporation has more liabilities (other than capital stock) than assets.[7] In addition, although section 64 of the Bankruptcy Act[8] incorporates R.S. § 3466 into Chapters I through VII by indirect reference[9] section 64 was expressly made inapplicable to Chapter X.[10]

The trustee in the principal case argued that R.S. § 3466 should not be deemed applicable to Chapter X proceedings in the absence of a provision incorporating it. He cited *Davis v. Pringle*,[11] which held R.S. § 3466 inapplicable to the Bankruptcy Act as it then read. In *Davis* the Supreme Court considered the 1906 version of section 64,[12] which gave priority to "any person who by the laws of the United States is entitled to priority . . ." and decided that "any person" did not include the United States; therefore it was held that this passage was not intended to be an indirect reference to R.S. § 3466. After thus disposing of the possibility that section 64 might serve to incorporate R.S. § 3466 into the Bankruptcy Act, the *Davis* Court refuted the proposition that R.S. § 3466 should nevertheless apply to the Bankruptcy Act because of its nature as a general priority statute. The Court reasoned that the terms of the Bankruptcy Act dealing with priorities (section 64) were all-encompassing and therefore exclusive, preventing the application of R.S. § 3466. Congress subsequently amended section 64,[13] expressly including the United States in the term "persons." As a result, R.S. § 3466 now applies to Chapters I through VII. However, the reasoning of *Davis* regarding the exclusiveness of the priority provisions would still seem applicable in Chapter X, where there

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7. See Bramwell v. United States Fid. Co., 269 U.S. 483, 487 (1926); United States v. Fabricated Air Prods. Co., 206 F. Supp. 228 (E.D. Tex. 1962).

8. 30 Stat. 563 (1898), as amended, 11 U.S.C. § 104 (Supp. V, 1964), provides in part: "(a) The debts to have priority, in advance of the payment . . . to creditors, and to be paid in full out of bankrupt estates, and the order of payment, shall be . . . (5) debts owing to any person, including the United States, who by the laws of the United States in [*sic*] entitled to priority. . . ."

9. The phrase in § 64a(5) which grants priority to any person "who by the laws of the United States is entitled to priority. . . ," clearly refers to R.S. § 3466. 3 COLLIER, BANKRUPTCY § 64.501 (14th ed. 1964). There are cases which hold that R.S. § 3466 is not applicable to proceedings in bankruptcy. Adams v. O'Malley, 182 F.2d 925 (8th Cir. 1950); *In re* Taylorcraft Aviation Corp., 76 F. Supp. 81 (N.D. Ohio 1947), *aff'd*, 168 F.2d 808 (6th Cir. 1948). These, however, appear to be based upon an erroneous conception that § 64 entirely abrogates R.S. § 3466 whereas it seems more accurate to consider that § 64 is in *pari materia* with R.S. § 3466, and partly supersedes it. See *In re* Jacobson, 263 Fed. 883 (7th Cir. 1920).

10. 52 Stat. 883 (1938), 11 U.S.C. § 502 (1958). Section 64 was eliminated from Chapter X because the rigid scheme of priorities established by it was regarded as unsuitable in reorganizations. 6 COLLIER, *op. cit. supra* note 9, § 9.13(2).

11. 268 U.S. 315 (1925).

12. 30 Stat. 563 (1898), as amended, 34 Stat. 267 (1906).

13. 44 Stat. 666 (1926). See note 8 *supra*.

is no incorporation of R.S. § 3466 because section 64 is expressly excluded. Nevertheless, the majority in the principal case concluded that R.S. § 3466 should be held inapplicable only if the terms of Chapter X evidenced an intention to cover all matters of priorities or were inconsistent with R.S. § 3466; and they found neither such exclusivity nor such inconsistencies. The court reasoned that Chapter X was intended to include all the priorities available in equity receivership cases because of its equity receivership background, referred to in section 115 of the chapter.[14] Since the priorities *expressly* provided for in Chapter X do not encompass the broad range of priorities found in equity receivership cases, the court concluded that the express priorities were not meant to be exclusive. In addition, the court noted that section 199 of Chapter X, which gives only tax and customs claims priority, is applicable in the reorganization of "solvent" as well as "insolvent" corporations. Therefore, the court apparently reasoned, section 199's grant of priorities has a different scope from that of R.S. § 3466, the latter applying only to "insolvent" corporations, and thus section 199's inclusion in Chapter X is not inconsistent with the application of R.S. § 3466 to Chapter X.[15]

Even though the court's reasoning appears logical, its choice of language here is somewhat misleading, for it is clear that section 199 does not unqualifiedly apply to solvent corporations. The provisions of Chapter X cannot be invoked unless certain insolvency requirements are met. Chapter X requires all reorganization

14. 52 Stat. 884 (1938), 11 U.S.C. § 515 (1958), which provides that the court shall "exercise all the powers . . . which a court of the United States would have if it had appointed a receiver in equity of the property of the debtor on the ground of insolvency or inability to meet its debts as they mature."

A draftsman of Chapter X testified before the Senate Judiciary Committee that the priorities applicable under Chapter X would be those indicated in equity receivership cases. John Gerdes, *Hearings on H.R. 8046 Before a Subcommittee of the Senate Committee on the Judiciary*, 75th Cong., 2d & 3d Sess. 77 (1937-38). Section 77B of the Bankruptcy Act, 48 Stat. 912 (1934), was clearly formulated to supplant the equity receivership procedure, the most popular means of reorganizing a corporation before 1934. 6 COLLIER, *op. cit. supra* note 9, § 3.17. The goals of bankruptcy and reorganization proceedings are divergent; the former having the object of liquidating for the benefit of creditors, while the latter contemplates continuance of the corporation as a going concern. The limitation by § 77B of the right of non-assenting creditors to demand cash settlements was held constitutional as an exercise of the bankruptcy power. See FINLETTER, *op. cit. supra* note 4, at 3. Before the enactment of 77B there were three ways of achieving corporate reorganization: through a voluntary arrangement entered into between the debtor and its creditors; through formal bankruptcy procedure, using the composition section of the Bankruptcy Act (§ 12) or using bankruptcy sale to purchase assets by arrangement with the creditors; and through an equity receivership obtained on a creditor's bill. 6 COLLIER, *op. cit. supra* note 9, § 0.01.

15. The court also considered the argument that §§ 107 and 216, which deal with creditors' rights under Chapter X, were inconsistent with R.S. § 3466 priority. Citing Guarantee Co. v. Title Guar. Co., 224 U.S. 152 (1912), the court responded to these arguments by noting that the United States "is not bound by provisions of an insolvency law unless specifically mentioned therein." Principal case at 116.

petitions to state "that the corporation is insolvent or unable to pay its debts as they mature."[16] The inability to pay debts as they mature is the equity standard for insolvency,[17] and its incorporation into the Bankruptcy Act reflects the equity receivership history of Chapter X.[18] Use of this insolvency test permits the initiation of proceedings before the floundering corporation is so far in debt that it cannot be successfully reorganized.[19] Thus the difference in scope between section 199 and R.S. § 3466 is not so great as the court's language implies. Section 199 merely renders tax and customs priority uniformly applicable under all Chapter X proceedings. But the nontax claims of R.S. § 3466 will not be uniformly applicable. There would seem to be no rational basis for giving the Government's nontax claims highest priority under some Chapter X proceedings (when the corporation meets the bankruptcy insolvency requirement and thus R.S. § 3466 can be invoked) while giving them no priority at all under others (when only the equity insolvency requirement is met and R.S. § 3466 is not available). In no other place in the chapter does the type of insolvency engender such a functional dichotomy.[20] Perhaps this is a valid indication that Congress intended to give no priority at all to nontax claims. The court does not answer the question why Congress, if it had wanted to insure the application of R.S. § 3466, did not take the simple and obvious step of including a provision in Chapter X to that effect. This congressional omission would seem circumspect in light of the previous necessity of amending the Bankruptcy Act after *Davis v. Pringle.*[21]

However, the use of R.S. § 3466 in equity receiverships was by no means automatic. Even when the strict balance sheet insolvency requirement was met, the courts did not feel obliged to apply R.S. § 3466 if policy considerations suggested otherwise. Two cases con-

16. Section 130(1), 52 Stat. 886 (1938), 11 U.S.C. § 530 (1958).

17. 6 COLLIER, *op. cit. supra* note 9, § 4.14(2).

18. See generally Blair, *The Priority of the United States in Equity Receiverships*, 39 HARV. L. REV. 1 (1925), for a thorough discussion of the R.S. § 3466 insolvency requirement.

19. 6 COLLIER, *op. cit. supra* note 9, § 4.14(2).

20. See Silver & Tondel, *Reorganization Under Section 77B of the Bankruptcy Act—1934-1939*, 49 HARV. L. REV. 1111, 1179 (1936), where it was suggested that the difference in insolvency requirements between R.S. § 3466 and § 77B, the predecessor of Chapter X, might preclude the application of R.S. § 3466. It was assumed that the 1935 amendment to § 77B, 49 Stat. 965 (1935), which added the forerunner of § 199, resolved the question even though the amendment did not pertain to nontax matters.

21. Some commentators have expressed the view that since Chapter X has no provision similar to § 64, the federal government has no priority by way of R.S. § 3466. Bernhardt, *Government Priority for Repayment of Monies Advanced to Contractors*, 20 REF. J. 35, 41 (1946); Friendly, *Some Comments on the Corporate Reorganizations Act*, 48 HARV. L. REV. 39, 60-61 (1934). In addition, an occasional case subsequent to the enactment of Chapter X holds that R.S. § 3466 has no application anywhere in the Bankruptcy Act, seemingly misconstruing the import of § 64 which incorporates R.S. § 3466 by indirect reference. See note 9 *supra*.

cerning the repercussions of government management of railroads during World War I provide illustrations. In *Mellon v. Michigan Trust*[22] the United States, in the person of the Director General of Railroads, asserted priority for transportation charges and tort claims against an insolvent corporation which had gone into equity receivership. The Court held that the policy manifested in the Federal Control Act[23] indicated that the United States, when engaged in a commercial venture, should have no greater rights than other creditors. In *United States v. Guaranty Trust Co.*,[24] the Court denied priority for a federal loan to a railroad which had become insolvent and had gone into equity receivership. By means of Title II of the Transportation Act of 1920,[25] which granted authority for making the loan, Congress meant to preserve the national railroad system by shoring up its somewhat unstable post-war credit. The Court observed that to give priority to debts due the United States would defeat this policy of Congress, as the prospect of the United States in the position of a privileged creditor could hardly encourage the re-establishment of railroad credit among bankers and investors.[26] Similar policy considerations were not so persuasive in the case of *United States v. Emory*,[27] which held R.S. § 3466 applicable to a United States claim under the National Housing Act in an equity receivership proceeding. The Court, after holding that the R.S. § 3466's insolvency requirements had been met, determined that the purpose of the priority statute was "to secure adequate public revenues to sustain the public burden. . . ."[28] However, a strong dissent pointed out that the Housing Act was not a revenue measure, but was intended to stimulate recovery and employment in the construction industry.[29] The dissent then declared that it had been "apparent that, each time this Court has considered legislative purpose as to R.S. § 3466 in relation to government claims under public financial legislation affecting creditors competing with the Government, it has determined that R.S. § 3466 did not apply."[30]

As the language of these cases indicates, policy considerations present when considering government priority for nontax claims may be significantly different from those which exist in tax and customs situations. Many of the federal government's nontax claims

22. 271 U.S. 236 (1926).

23. 40 Stat. 451, 456 (1918) provided that the carriers while under federal control would be subject to all laws and liability as common carriers, and it stripped them of immunity from suit.

24. 280 U.S. 478 (1930).

25. 41 Stat. 456, 457-69 (1920).

26. 280 U.S. 478, 485 (1930). *Cf.* Cook County Nat'l Bank v. United States, 107 U.S. 445 (1882).

27. 314 U.S. 423 (1941).

28. *Id.* at 426.

29. *Id.* at 435.

30. *Id.* at 437.

arise from federal activity in the realm of private enterprise, such as loans under the Federal Housing and Small Business Acts or from the operation of facilities which historically are not essentially governmental functions, such as the wartime management of railroads or TVA.[31] Here it would not seem unjust to strip the government of the sovereign priority which R.S. § 3466 represents. The government as a tax collector should not be considered an ordinary creditor, for in this role it has no choice of debtors; it is the creditor of all taxpayers.[32] But the government as a lender of money or renter of services does have a choice of debtors. Therefore, it becomes possible to exercise the prudence that a private creditor finds necessary, and in fact such prudence may be provided for in the acts authorizing government extension of credit.[33] It is arguable that it was just these considerations which prompted Congress to allow the government highest priority for tax and customs claims through section 199, although it made no corresponding mention of nontax claims. The brief dissent in the principal case apparently takes cognizance of these arguments, maintaining that it is not unreasonable in the reorganization of a business enterprise that all claims of the same class should be treated alike.

The facts of the principal case itself provide a striking example of how the application of R.S. § 3466 to nontax claims may defeat the policy embodied in a congressional act. One of the government claims[34] was filed by the Small Business Administration, which was created for the purpose of joining with private lenders in making available loans to small business concerns that are unable to obtain capital improvement loans on reasonable terms from private lenders.[35] It was created not to supplant or compete with private credit sources but to encourage and cooperate with them.[36] The priority now granted to SBA claims lends itself to the opposite result: private creditors must now be wary of any government

31. As early as 1924 it was said that "the contractual operations of the federal government and of the states have become so extensive and so involved with the business of private citizens that priority to the federal government and to the states, except for taxes, would operate as an oppressive hardship on other creditors of bankrupts." Davis v. Pringle, 1 F.2d 860, 864 (4th Cir. 1924), *aff'd*, 268 U.S. 315 (1925).

32. See generally Friesen, *Collection of Federal Taxes Out of the Taxpayer's Property—A Judicial Shell Game*, 9 KAN. L. REV. 263, 264 (1961).

33. Referring to the Transportation Act of 1920, 41 Stat. 456, 457-69, the court in United States v. Guaranty Trust Co., 280 U.S. 478, 485 (1930), said, "the giving of adequate security was either required or left to the discretion of the President. Under § 210 no advance could be made, unless . . . [there was] . . . reasonable assurance that the loan would be repaid. . . ."

34. Principal case at 113.

35. See, *e.g.*, Small Business Administration v. McClellan, 364 U.S. 446 (1960); W. T. Jones & Co. v. Foodco Realty, Inc., 318 F.2d 881 (4th Cir. 1963); Gilbertson, *Small Business Financing Under the Small Business Act and the Small Business Investment Act of 1958*, 8 KAN. L. REV. 538, 539 (1960).

36. See Gilbertson, *supra* note 35, at 552.

nontax claims against a corporation.[37] Private lenders "cooperating" with the SBA can be injured because government priority for SBA loans has been held to apply only to that portion of the debt actually loaned by the SBA; otherwise the priority provided in R.S. § 3466 would not operate solely for the purpose of securing the government an adequate revenue, but would also serve to benefit private persons.[38] Thus a private lender acting in concert with the SBA could find itself cut off from any share in the debtor's assets by the SBA's priority.

The decision in the principal case represents a significant expansion of R.S. § 3466 priority into an area where it previously had not clearly been deemed applicable.[39] Once applicable, the R.S. § 3466 priority has been held to take precedence over many pre-existing liens through a development of the doctrine of the inchoate lien. This doctrine makes only the most definite liens, if any, effective against federal priority under R.S. § 3466.[40] The United States now enjoys by virtue of R.S. § 3466 a highly privileged position in Chapter X proceedings, possibly beyond that which would be deemed proper even under the English common-law sovereign prerogative doctrine. Even if the majority in the principal case had demonstrated that R.S. § 3466 is not in conflict with the provisions of Chapter X, it has not shown any affirmative congressional intention that R.S. § 3466 should apply to the Chapter. Such

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37. In an article which concluded that the generally strong federal priority had an unfortunate effect on the extension of private credit, the SBA was somewhat ironically described as an "attempt to aid debtors through stimulating loans by private creditors who have, with good cause, become wary." MacLachlan, *Improving the Law of Federal Liens and Priorities*, 1 BOSTON COLLEGE INDUSTRIAL & COMMERCIAL L. REV. 73, 80 (1959).

38. See Nathanson v. NLRB, 344 U.S. 25 (1952); W. T. Jones & Co. v. Foodco Realty, Inc., 318, F.2d 881 (4th Cir. 1963).

39. One other case, Matter of Cherry Valley Homes, Inc., 255 F.2d 706 (3d Cir. 1958), *cert. denied*, DuBois v. United States, 358 U.S. 864 (1958), has held, as an alternative ground, that R.S. § 3466 applies to Chapter X proceedings. In that case the United States had levied on the property of a taxpayer for taxes and served appropriate notice on a corporation which owed a liquidated sum to the taxpayer. The corporation was not insolvent at the time of the levy and did not file a reorganization petition until five months later. As the primary ground for granting the United States priority, the court held the levy effectively and exclusively appropriated the debt to the satisfaction of the tax claim. As a second ground, the tax levy was held to accomplish at law an assignment of the taxpayer's claim to the United States and R.S. § 3466 was applied.

40. For a thorough treatment of this development, see generally Kennedy, *The Relative Priority of the Federal Government—The Pernicious Career of the Inchoate and General Lien*, 63 YALE L.J. 905 (1954). For a lien to be specific and not inchoate, it must be definite in three respects: (1) the identity of the lienor; (2) the amount of the lien; (3) the property to which it attaches. See Illinois *ex rel.* Gordon v. Campbell, 329 U.S. 362 (1946); Annot., 36 A.L.R.2d 1204. Since the courts have established the doctrine, no law has yet been found by the Supreme Court to be sufficiently "choate" to override the federal priority in any case in which the statute has been applied.

an extension of this potent federal priority without a clear congressional mandate would seem open to question in view of the noted dissimilarity between tax and nontax policy considerations.[41]

41. A bill to amend R.S. § 3466, which would substantially reduce federal priority, has been introduced into the House of Representatives. State and local taxes would be accorded equality with federal taxes, and all taxes would have lower priority than administrative and funeral expenses and wage claims. United States nontax claims would be given equal priority with rent claims, which follow taxes. H.R. 4953, 88th Cong., 1st Sess. § 201 (1963). *But see* H.R. 12545 and 12546, introduced Sept. 2, 1964.