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Entity Receiverships and the Dangerous Federal Priority Statute

Lawyers representing creditors often compete with federal government claims against the same insolvent borrower/debtor.

There are several common federal statutes that impact these disputes including: 11 U.S.C. Section 507^[1]; 26 U.S.C. Section 6321^[2], *et seq.*; and 31 U.S.C. Section 3713.

Lawyers representing creditors often seek the appointment of a receiver. When considering that action, collection counsel often has two choices:

- Most often, a receiver is sought to control specific property of the borrower/debtor that is liened by the creditor and based on either a statute or a contractual consent to that appointment. 75 C.J.S. Receivers Section 92 (Mar. 2018) (“As a general rule, the receiver takes all the property of the debtor which constitutes the subject of the suit and is within the jurisdiction of the court; he or she does not take property not involved in the suit . . .”) Thinking particularly of Ohio, see, O.R.C. Sections 2735.01 *et seq.* for Ohio’s statutory grounds and *S. Bank, N.A. v. Gotham King Fee Owner, L.L.C.*, 2013 WL 2149992 (Cuyahoga Cty. App. May 16, 2013) (“By contractually consenting to the appointment of a receiver, Gotham waived its right to oppose the appointment of a receiver and the requirements of [R.C. 2735.01](#).”); or
- Alternatively, and less frequently, an “entity receiver” is sought to control the borrower/debtor. This type of receivership is more difficult to obtain. See, 80 O. Jur.3d Section 34 *Receivers* 34 titled “Judicial Reluctance to Appoint Corporate Receivers” which states “As a general rule, courts of equity act with the greatest reluctance and caution in appointing receivers for corporations and employ the greatest circumspection in the exercise of their discretion. . . . The extraordinary remedy of receivership with regard to a corporation is justified only in a strong and clear case or in extreme cases . . .”

An entity receivership can give a court control of all of a borrow/debtor's assets and prevent dissipation of those assets. But, this choice is not without serious potential negative consequences.

This blog post will discuss the danger that arises when collection lawyers fail to analyze the interplay between entity receiverships and 31 U.S.C. Section 3713[3] which states:

- A claim of the United States Government *shall be paid first* when—
 - 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
 - the estate of a deceased debtor,[4] in the custody of the executor or administrator, is not enough to pay all debts of the debtor.
- This subsection does not apply to a case under title 11.
 - *A representative of a person or an estate (...) 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. (italics added)*

Section 3713 is a statute of general application – it applies in all situations that are not controlled by a more specific statute. *United States v. Estate of Romani*, 118 S.Ct. 1487 (1998) (federal tax lien statute [26 U.S.C. Section 6321, *et seq.*] controlled giving creditor's judgment lien priority over the government's tax lien and underlying tax claim despite the clear language of Section 3713 requiring that federal government's claims "shall be paid first.")

While it can be avoided, when applicable, the federal priority statute is dangerous to non-federal government creditors. The danger of Section 3713 is the personal liability imposed by subsection b, quoted above, which makes Section 3713's targeted payors very reluctant to pay creditors unless the government's current and

future claims are paid in full. [\[5\]](#) Hence, lawyers representing creditors should avoid triggering the application of Section 3713, if possible, unless the benefits of the triggering event outweigh the value of the government claims that are lifted to priority by Section 3713.

Although not used in the statute, it is commonly said that the liability of Section 3713(b) can attach to any court appointed “fiduciary” who fails to honor the government’s priority by distributing funds to other claimants while the federal government’s current and future claims remains unpaid. For example, Internal Revenue Manual 5.17.13.7 titled “Personal Liability of the Fiduciary Under 31 USC § 3713(b)” includes:

- [31 USC § 3713\(b\)](#) imposes **personal liability on a fiduciary or representative** of an insolvent person or estate if the fiduciary:
 - (A) has knowledge of the federal tax debt, and
 - (B) pays other debts before paying the priority tax claims. . . .
- Examples of the types of fiduciaries include executors, administrators, and personal representatives of insolvent estates; **receivers**; assignees; . . . The common characteristic of persons liable under [31 USC § 3713\(b\)](#) is that *“they are given possession and control of assets of debtors and are charged with the payment of debtors’ obligations consistent with the creditors’ rights and priorities.”* [King v. United States, 379 U.S. 329\(1964\)](#); [United States v. Whitney, 654 F.2d 607 \(9th Cir. 1981\)](#); [United States v. Crocker, 313 F.2d 946, 949 \(9th Cir. 1963\)](#) (holding the fact that a receiver is appointed by the court does not make the receiver immune from liability).

IRS regulations, which have more authority than the Internal Revenue Manual, echo this position. Treas. Reg. 601.109(d) (“Under section 3466 of the Revised Statutes and section 3467 of the Revised Statutes, as amended, **taxes are entitled to priority over other claims** therein stated and **the receiver or other person designated as in control of the assets or affairs of the debtor by the court in which the receivership proceeding is pending may**

be held personally liable for failure on his part to protect the priority of the Government respecting taxes of which he has notice.”)

In *United States v. Whitney*,^[6] cited by the IRS, a court-appointed receiver was found liable under Section 3713 because “the degree of control and possession which Whitney exercised over the taxpayer’s assets and the authority with which he disbursed the taxpayer’s funds in payment of the taxpayer’s debts warrant the imposition of personal liability upon him . . .” *Accord, Federal Trade Commission v. Crittenden*, 823 F. Supp 705 (U.S.D.C. C.D. Calif. 1993) (receiver appointed after the FTC seized a business was required to give priority to the business’ tax debt and therefore the court granted the “IRS Motion to Disallow the Receiver’s Intended Distribution.”). The *Whitney* and *Crittenden* cases involves a debt collected by the IRS; other federal agencies recently using Section 3713 have included the Environmental Protection Agency (CERLA liability), Homeland Security (import related charges) and the Department of Justice (breach of contract claim and a Medicare reimbursement claim).

In line with those cases and the IRS’ position, the Department of Justice Resource Manual, Title 4 Number 206, captioned “Priority for the Payment of Claims Due the Government” includes this:

The Priority Statute applies to all claims of the United States. . . . Debts payable in the future are also covered by the statute. . . . The statute applies even though the government’s claim has not yet progressed to judgment. *United States v. Moore*, 423 U.S. 77, 80–83 (1975) (statute does not distinguish between liquidated and unliquidated claims; “the courts have applied the priority statute to government claims of all types.”); *United States v. Gilbert Associates, Inc.*, 345 U.S. 361 (1953) (municipal tax lien subordinate to federal priority claim for taxes where municipal lien was only a general unperfected lien on all of debtor’s property); *United States v. Moriarity*, 8 F.3d 329, 334 (6th Cir. 1993) (“claim” in priority statute interpreted expansively to include right of payment whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured or unsecured.) . . .

For purposes of [§ 3713\(a\)\(1\)\(A\)\(iii\)](#), acts of bankruptcy [which makes Section 3713 applicable] include the following (see Bankruptcy Act, § 3, 11 U.S.C. § 21 (1976)):

- making a preferential payment to a creditor on an antecedent debt;
- committing a fraudulent conveyance;
- concealing assets with an intent to hinder, delay or defraud creditors;
- **permitting a creditor to obtain judicial lien on property;**
- making a general assignment for the benefit of creditors; or,
- **permitting a receiver or trustee to be appointed over all property.**

Whether a secured creditor is subject to the priority statute may depend on whether its secured lien is sufficiently perfected and specific to except it from the broad reach of [§ 3713](#). The Supreme Court espouses a stringent standard that requires the lienor actually to take title to, or possession of, the property to be exempt from [§ 3713](#).

The reach of Section 3713 extends beyond the government's existing perfected liens with priority over whatever claims a collection lawyer's creditor clients may possess. Section 3713 protects the government when its perfected liens do not have priority and no other statute protects the non-governmental creditor. *Law Office of Jonathan A. Stein v. Cadle Company*, 250 F.3d 716 (9th Cir. 2001) (holding that Section 3713 protected the government when the federal tax lien act did not apply, the Ninth Circuit said "[d]oes [26 U.S.C. § 6323](#) [the federal tax lien act] control the determination of claim priority when the government has a judgment under [26 U.S.C. § 6332\(d\)](#) against a person who failed or refused to honor a levy [from the IRS]? We hold that it does not. Therefore, the district court correctly determined that the United States had [§ 3713](#) priority.")

To avoid creating problems for his clients a collection lawyer needs to:

- understand what federal government claims exist now or may exist in the future against the borrower/debtor that are not already secured by perfected liens in favor of the government with priority over the client's perfected liens (if any);
- be certain that any available consensual liens in his client's favor are perfected to the maximum extent possible;
- know if any specific federal statute controlling debt collection priority applies to supersede the general priority statute, Section 3713^[7];
- carefully consider the value to your client before taking actions that would cause Section 3713 to become applicable such as (i) taking a judicial lien,^[8] or (ii) seeking the appointment of an entity receiver^[9] over all the borrower/debtor's property; and
- compare the benefit to your client generated by the triggering act against the danger in making Section 3713 applicable.

As with many legal problems, the case's specific facts matter. An experienced and thoughtful collection lawyer will analyze the borrower/debtor's other actual and potential creditors and plan litigation strategy that does not inadvertently worsen the client's position. For more information, please contact Vince Mauer at vmauer@fbtlaw.com.

^[1] Bankruptcy Code Section 507 sets the priority of unsecured tax claims and certain other federal government claims.

^[2] All assessed income tax claims are secured by the IRS' "secret lien." That lien does not always take priority over other claims. See, 26 U.S.C. Section 6323 and <https://www.blockchainandbanking.com/irs-liens-after-acquired-property-and-the-doctrine-of-choateness>.

^[3] Captioned "Priority of Government Claims," when applicable, this statute creates a payment priority for any "claim of the United States Government." The text of this statute is virtually unchanged since 1797.

^[4] Section 3713 was potentially applicable in the *Estate of Romani* case because it involved an insolvent probate estate.

[5] Section 3713 applies to receiverships and future government claims. *S.E.C. v. Credit Bancorp Ltd.*, 297 F.3d 127 (2nd Cir. 2002).

[6] According to a citing court, the *Whitney* decision applied Section 3713 because “[w]hen a company is insolvent and ‘payments were made to creditors other than the United States in derogation of its claim for federal employment taxes [owed] to the government,’ an act of bankruptcy within the meaning of [31 U.S.C. § 3713](#) [is committed] . . .” *U.S. Dept. of Justice v. Sperry*, 2013 WL 1768664 (U.S.D.C. S.D. Ind. April 24, 2013).

[7] Besides the federal tax lien statute discussed above, other federal debt collection laws applicable to certain specific types of debts to the federal government are also subject to a specific statute and not the general rule of Section 3713. For example, federal claims against national banks are controlled by the National Bank Act which controls distribution of assets by insolvent banks and federal claims against railroads arising under the Transportation Act of 1920 have been held to be outside the general rule of Section 3713.

[8] Creditors taking a judgment lien cause Section 3713 to apply because it is an act of bankruptcy. Worse, that lien may not help the judgment creditor’s claim against the insolvent borrower/debtor vis-a-vis the federal government’s claim. *Cardinal Construction Co. v. Besmec, Inc.*, 701 F. Supp. 1274 (U.S.D.C. S.D. W.Va. 1988) (“In addition, [§ 3713](#) confers priority on the government over subsequently created choate liens.”)

[9] Separate from potentially causing Section 3713 to apply, appointment of an entity receiver may cause the IRS to become more active. Treas. Reg. § 601.109(a)(1) states “[u]pon . . . the appointment of a receiver for any taxpayer in any receivership proceeding before a court of the United States . . . , the assessment of any deficiency in . . . tax (together with all interests, additional amounts, or additions to the tax provided for by law) shall be made immediately. . . . In such cases the restrictions imposed by [section 6213\(a\)](#) of the Code upon assessments are not applicable [governing pre-assessment notices of deficiency]. . . . Cases in which immediate assessment will be made include those of

taxpayers in receivership . . .” See *also* Treas. Reg. § 301.6871(a)–1 titled “Immediate assessment of claims for income, estate, and gift taxes in bankruptcy and receivership proceedings.” A receiver cannot secretly attempt to avoid Section 3713 and the IRS issues because IRS regulations and the Internal Revenue Code require that the appointed receiver give notice to the IRS. See, Treas. Reg. § 601.109(a)(1), Treas. Reg. § 6903–1 and 26 U.S.C. Section 6903

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