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## Understanding the Impact of the Federal Priority Act on Receivers

By Claire M. Schenk

The work of a receiver can be a difficult balancing act. With various creditors and debts that need to be paid, there can be a long and meticulous resolution process. In order for receivers to protect themselves from the risk of personal liability for claims made by the government, it is imperative that receivers understand the Federal Priority Act ("FPA").

The idea that court-appointed receivers may be held individually liable for court-approved payments is a surprising and frightening possibility. As many of us

know and appreciate, receivers are officers of the court and are typically afforded significant leeway and deference in the interpretation and application of equitable principles. However, the FPA has a long reach and permits a receiver to be held liable under certain circumstances.

The FPA was passed in the late 1790s. It "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). For receivers, the FPA can be a mysterious,

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## Selling Minority and Partnership Interests in Real Estate

By Todd B. Wohl

*The Practitioner's Corner is a regular feature where NAFER members can contribute their personal perspective on issues facing receivers.*

One of the most challenging tasks facing receivers is to address the sale process and obtain market value of minority, partnership and fee simple interests of real estate.

The case of Dipak Desai is a great example.<sup>1</sup> Desai, a Las Vegas physician, filed for personal Chapter 11 bankruptcy in 2010 roughly two years after his medical clinic was implicated in a hepatitis C outbreak.

His case was converted to a Chapter 7 proceeding in 2011.<sup>2</sup> The trustee had a fee simple interest in multiple parcels of real estate and a portfolio of 38 minority partnership interests in commercial real estate in Nevada, Arizona and California. Initially, the trustee saw a little value in the partnership interests and focused on the real estate due to the complexities of understanding

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sometimes frightening tool that the government can rely upon to impose personal liability for unpaid debts to the government. While receivers act as an arm of the court, history has made clear that they are not immune from personal liability under the FPA.

According to the FPA, personal liability is imposed on representatives of persons or estates that pay any debts prior to government claims. A representative is liable to the extent of the “unauthorized” payment. While receivers are not expressly mentioned within the language of the FPA, courts have imposed liability on receivers who have paid debts prior to the resolution of the government’s claims.

The FPA, 31 U.S.C. § 3713, mandates that federal government claims receive first priority for payments when two conditions are satisfied:

- (1) The federal government’s debtor is insolvent, and
- (2) The debtor
  - (a) makes a voluntary assignment of property without enough property to pay all debts; or

- (b) attaches the property of the debtor; or
- (c) commits an act of bankruptcy. 31 U.S.C. § 3713(a).<sup>1</sup>

To take priority, the government debt must be already 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 statutory 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).

### What Constitutes a Claim

The FPA defines a “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.” 31 U.S.C. § 3701(b)(1) Although in practice it can be very difficult to put forward a precise definition of a claim considering the expansive definition courts have utilized, it appears that the government can pursue a claim under the FPA as long as a debt to the federal government existed when the act of bankruptcy was committed.<sup>2</sup>



## President’s Letter

Kevin B. Duff,  
NAFER President

**I**n 2019, NAFER continued with its mission of great education and networking for its members and the receivership community. Hard work and the many talents of its members and leadership have made NAFER the preeminent organization for federal equity receivers, their professionals, and others seeking to become involved in federal equity receivership work. But that job is not done. It will challenge us every year, as we grow, evolve, and change. In 2020, NAFER needs to continue with these important efforts.

Successful receivers are good listeners, who gather information and then act on it. At our recent annual conference in Scottsdale, Arizona, we heard a call from judges and regulators for greater diversity in receivership opportunities. NAFER must answer that call and strive for equity in ways that stretch beyond the receiverships in which we serve. We also are called to seek equity in opportunity within the receivership community and beyond.

Consistent with the themes I have asked members to bear in mind over the past year, I ask you to work hard and be mindful in the coming year of the need to embrace diversity and change as an opportunity for new successes: Tag diverse talent. Invite new involvement. And promote people for whom doors may not otherwise be open. In doing so, NAFER will grow stronger and will succeed in ways that fresh eyes will help us see.

Speaking of opening doors, if you have not heard, NAFER now has a new membership opportunity for young professionals. If you work with or know young professionals who are not currently NAFER members, encourage them to become a member. Not only will they enjoy substantial discounts on membership dues and conference attendance fees, but they will receive unparalleled receivership education and networking opportunities.

NAFER’s new web site is another forum of tremendous potential for NAFER and its members. As we roll it out in the coming months, the web site will serve as an excellent resource for receivers, their professionals, and those looking to appoint receivers. The web site also will give members the ability to connect with each other, share information about themselves, and contribute in many ways that will benefit both members and other web site visitors.

2020 also will see another lineup of NAFER’s top shelf education and networking events. We are looking forward to regional events in New York, Los Angeles, and other cities. NAFER’s Offshore Conference will take place on March 4-5, in Miami, Florida. The Annual Conference will be October 8-10, at the J.W. Marriott in Washington, D.C. Please mark your calendar for these NAFER events that you will not want to miss. More information is available on NAFER’s web site, [www.NAFER.org](http://www.NAFER.org), or by contacting Jennifer Brinkley, NAFER’s Executive Director, at [Jennifer.Brinkley@NAFER.org](mailto:Jennifer.Brinkley@NAFER.org).

Finally, take time for thoughtfulness this holiday season. And get involved in the new year!

Wishing you and yours the very best,

Kevin Duff  
NAFER President

## Liability of Representatives of the Debtor

A representative is not strictly liable for paying debts prior to government claims. 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 before liability can be imposed.<sup>3</sup>

The U.S. Court of Appeals for the Eighth Circuit has stated that the liability of a representative depends 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).<sup>4</sup>

Prior to 1964, courts took differing approaches to whether a receiver should be held personally liable under the FPA. Some jurisdictions had determined that a receiver should not be held personally liable because, unlike a representative such as an executor, a receiver is "an officer or arm of the court." *United States v. Stephens*, 208 F.2d 105, 109 (5th Cir. 1953). Other jurisdictions came to the opposite conclusion, comparing a receiver to a trustee in bankruptcy, and determining that receivers could be held personally liable under the statute. *United States v. Crocker*, 313 F.2d 946, 949-50 (9th Cir. 1963). *United States v. Sachs*, 217 F. Supp. 545, 547 (D. Md. 1963).

In 1964, the U.S. Supreme Court interpreted the FPA, explain-

ing that the "distinction between a personal representative and an agent of the court is misplaced." *King v. U.S.*, 379 U.S. 329, 337 (1964). In *King*, the Supreme Court held a distributing agent personally liable for a company's unpaid government debts. The Supreme Court held that whether to impose personal liability is not a question of "title of...position," but "upon the degree of control [one] is in a position to assert." *Id.* at 337. The Court cited *U.S. v. Crocker* and confirmed that receivers, as well as distributing agents, could be held personally liable under the FPA.

Since *King*, receivers have been held liable under the "degree of control" theory. In *United States v. Whitney*, 654 F.2d 607, 612 (9th Cir. 1981), the receiver for a hospital was held personally liable for the hospital's unpaid employment and unemployment taxes. The receiver had been given notice by the IRS of the tax claims and the government's priority over the hospital's other obligations. The receiver paid part of the money due to the IRS but also paid off other creditors, rendering the receiver unable to completely resolve the debts due to the IRS. The Ninth Circuit held that the receiver exercised "a degree of control and possession...over the taxpayer's assets" that warranted the imposition of personal liability upon him. *Id.* at 612. The district court imposed a judgment against the receiver for approximately \$12,000 plus interest, which the appellate court affirmed. Cases such as *Whitney* illustrate the real risk of personal liability that a receiver can face and the dangers of paying creditors and debts prior to government claims.

While claims from the government have priority over claims from other creditors, "it has long been settled that administration expenses of a receivership take precedence over claims asserted by the Government." *United States v. Idaho Falls Assoc. Ltd. P'ship*, 81 F. Supp. 2d 1033, 1043 (D. Idaho 1999). Necessary and reasonable expenses that are "incurred by the receiver for the purpose of preserving the assets subject to receivership" take precedence over government claims.

## Limitations of the FPA's Reach

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 arise subsequent to the act of bankruptcy cannot be claims under the FPA.<sup>5</sup> 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.<sup>6</sup>

## Other Defenses

The FPA is a very broad statute, and, considering the expansive readings of the statute, it 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 suggest that there are exceptions to its coverage. *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.<sup>7</sup> Additionally, the federal government may not trump another party's lien where the party has gained possession or title to the debtor's personal property.

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In very narrow circumstances, the defense of reverse preemption can also arise. 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, absent an express intention of Congress, the states retain primacy in the area of insurance law. 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.

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. *U.S. v. 58th Street Plaza Theatre Inc.*, 287 F. Supp. 475, 496-97 (S.D.N.Y. 1968).

## Conclusion

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

### About The Author

#### Claire M. Schenk



Claire M. Schenk is a partner in the Business Litigation practice group at Thompson Coburn LLP in St. Louis. Claire has served as a receiver and handled federal equity receivership work throughout her career. She has served as a receiver for various federal agencies including the SBA, SEC and FTC. Layla F. Husen, a summer associate at the firm, assisted her in researching this article.

## ENDNOTES

- <sup>1</sup> Originally, the FPA only contained language regarding insolvency. *King v. U.S.*, 379 U.S. 329 (1964). Priority was later extended to include voluntary assignments, attachments of property, and acts of bankruptcy. Paired with insolvency, a voluntary assignment or attachment of property or an act of bankruptcy is sufficient to trigger the FPA.
- <sup>2</sup> 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). See, also, *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 statute to claims of all types." *United States v. Moore*, 423 U.S. 77, 80 (1975).

- <sup>3</sup> "[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).
- <sup>4</sup> *Kime* 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 (2d. 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 the executor distributed asset of estate, the estate was insolvent, and the executor had notice of a debt owed to the government before the distribution).
- <sup>5</sup> This concept is illustrated in *In Re Metzger*, 709 F.2d 32 (9th Cir. 1983). 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. 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. 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. 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. In short, debts not currently in existence, but which may arise in the future contingent on other events, cannot be claims.
- <sup>6</sup> 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.
- <sup>7</sup> The courts have consistently endeavored to outline the scope of the FPA in the tax law arena. Several federal cases have analyzed the interaction between the federal Tax Lien Act and the FPA. In *United States v. Estate of Romani*, the Supreme Court considered whether the FPA requires that a federal tax claim be given priority over a judgment creditor's perfected lien on real property. 523 U.S. 514 (1998). In *Romani*, Romani Industries obtained a judgment against Francis J. Romani and recorded the judgment at the clerk's office, which created a perfected lien on

Romani's property. Afterwards, the IRS filed a series of notices of tax liens on the same property. The question was whether the government was entitled, pursuant to the FPA, to prevent the transfer of the property to the judgment lien creditor because of the government's purported superseding priority. The Supreme Court held that the government was not entitled to priority. First, the Court acknowledged that the judgment lien was fully perfected under Pennsylvania state law prior to the government serving the notices of tax liens upon the estate. The Court then

noted that the Federal Tax Lien Act of 1966 (the final installment in a series of amendments to the Act) solidified congressional intent to broaden the protection of secured creditors from federal tax liens when no notice of those liens would have been available to the secured creditors. Given the express language of the Tax Lien Act, and because the judgment creditor in this case was not notified of federal tax liens on the property until after the judgment lien was created, the judgment creditor was entitled to the property. 🏠

## PRACTITIONER'S CORNER



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the marketability of the partnership interests.

After some analysis by Braun International's valuation team of the underlying real estate held in the partnership interests, we determined there was indeed substantial value. We suggested to the trustee to use our Worldbid auction and Minority Interest Market Exchange "MIMX" platform to sell the real estate and partnership interests. We then devised a structured global bespoke marketing and sale process that included a 60-day global marketing campaign and a two-tiered sealed bid auction of the real estate and partnership interests. We spelled out those procedures for the Bankruptcy Court and obtained the judge's approval. A data room was created with due diligence information available upon receipt of an executed bidder confidentiality agreement. Bidders were given the opportunity to conduct their due diligence during the marketing campaign. All bids were submitted on a purchase and sale contract approved by the trustee. Bidders provided their bids without any contingencies but with a proof of funds to purchase and a registration deposit. The initial round of bids was due by a specific date with certain pre-approved bidding terms to be met. Bids which met the criteria and which were in the top 33% could participate in the "highest and best" second round. The bids were then approved and the buyers confirmed.

We then marketed the partnership interests and real estate using a myriad of media, promotion and advertising methods: behavioral advertising, native advertising, search engine marketing, search engine optimization on Google and Bing, and listings on local, national and international real estate sites such as the Multiple Listing Service ("MLS"). Direct mail and digital mail was used to provide awareness to local real estate owners and brokers. Our marketing team conducted a sweeping tele-sales campaign to reach local and national buyers. We notified the limited partners in each of the partnership interests of the sale process, giving them the opportunity to participate.

The results were dramatic. We found that the existing limited partners were motivated to bid because of the urgency and competition we created, and the risk of losing an opportunity to purchase additional partnership interests to other limited partners. In other words, although Desai had filed an individual bankruptcy petition, his partnerships had not. Some of his investments were doing well. Our goal was to motivate his fellow

limited partners to buy his shares. We received 11 bids totaling nearly \$1.1 million for the partnership interests, which exceeded the Bankruptcy Court's expectations by 350% compared to their initial expectations of the sale price.

Why is this case study important to receivers, trustees, creditors, debtors and other parties? Because court-appointed professionals and their counsel often run the risk of under-valuing the assets of the estate. The result of this mistake leaves money on the table and means that the professionals are not fully discharging their responsibilities to their clients and the court.

What follows in the rest of this article is a deeper dive into the two common methods of selling real estate and partnership interests: brokerage and auction. Each has its own rules, its own advantages and disadvantages. In the *Desai* case, we used the auction process but in other instances, the brokerage option is a good fit. There is no one-size-fits-all approach. Trustees and receivers need to match the process to the facts at hand.

### The Brokerage Option

The brokerage method uses an individual or firm who charges a fee or commission to sell the real estate. It is the standard approach used in most real estate sales. The sellers of the real estate enlist a broker, who is expected to act as an unbiased third-person facilitator between the buyer and the seller. Brokerage firms tailor the listing term based upon the demands of the seller. Both commercial and residential properties are listed online through a regional or local MLS. The MLS then feeds this information to companies such as Zillow, Realtor.com, Trulia, Loopnet and Costar and dozens of other for pay "public" websites. For many brokers who wish to advertise their properties, online listing services function as a powerful and effective marketing tool for commercial and residential properties. Ninety-nine percent of buyers start their search on the Internet via countless number of listing websites all of which pull information from the MLS. These databases provide easy access to real estate information ranging from photos, historic listing information, city and state demographics and so much more. Interested buyers will then be able to search and find those properties that fit their criteria. Those are the basics that most homeowners understand.

But selling commercial real estate in a bankruptcy or receivership involves an added level of sophistication. There is a common

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