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B-170109 July 21, 1970

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The Honorable Wright Patman, Chairman Committee on Banking and Currency House of Representatives

Dear Mr. Chairman:

This is in response to your letter of June 19, 1970, requesting the opinion of this Office regarding certain aspects of a "proposed loan guarantee of up to $200 million to the Penn Central Transportation Company under section 301 of the defense Production Act."

Specifically, you requested our opinion as to whether the Federal Government, when acting as a guarantor for a loan made by a commercial bank, assumes a senior position with respect to other creditors of the assisted company through any provision of applicable law.

You also question the basic legality of the proposed loan guarantee, stating that the legislative history indicates that the act was intended primarily to assist small and medium - size defense contractors in full- filling contrasts for specific military hardware; and you raise a question as to the need for, and advisability of, such a commitment.

A further question has been informally raised - in connection with the loan guarantee - by staff members of your committee, as to whether the usual procedure of having the Office of Emergency Preparedness (OEP) certify as to the essentiality of the loan for defense purposes had been followed or whether the department of Defense (DOD) by- passed OEP in the instant case.

Section 301(A) of the Defense Production Act of 1950, as amended, 50 U. S. C. App. 2091 (a), provides, in pertinent part, as follows:

"In order to expedite production and deliveries or services under Government contracts, the President may authorize, *** the Department of the Army, the Department of the Navy, the Department of the Air Force, the Department of Commerce, and such other agencies of the United States engaged in procurement for the national defense as he may designate (hereinafter referred to as 'guaranteeing agencies'), without regard to provisions of law relating to the making, performance, amendment, or modification of contracts, to guarantee in whole or in part any public or private financing institution (including any Federal Reserve bank), by commitment to purchase, agreement to share losses, or otherwise, against loss of principal or interest on any loan, discount, or advance, or on any commitment in connection therewith, which may be made by such

financing any contractor, subcontractor, or other person in connection with the performance of any contract or other operation deemed by the guaranteeing agency to be necessary to expedite production and deliveries or services under Government contracts for the procurement of materials or the performance of services for the national defense ***."

Regarding whether the Government, when acting as a guarantor for a loan made by a commercial bank, assumes a senior position with respect to other debt holders of the assisted company, we find no provision in the Defense Production Act of 1950, as amended, which would require such a result in the event of a default by the debtor and subsequent payment of the debt by the United States under the terms of the loan guarantee.

Under such circumstances some protection is afforded the Government as a creditor under the provisions of 31 U. S. C. (R. S. 3466), which establishes a general priority for debts due the United States in cases of debtor insolvency or death, and section 64 (a) of the Bankruptcy Act, as amended, 11 U. S. C. 104 (a), which gives debts due the United States a fifth, of lowest, priority in bankruptcy proceedings. However, under both statutes as interpreted by court decisions severe limitations are placed upon the priority afforded the United States as a general (unsecured) creditor.

31 U. S. C. 191 provides:

"Whenever any person indebted 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 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. R. S. Sec. 3466."

Section 64a of the Bankruptcy Act, 11 U. S. C. 104 (a) provides, in pertinent part, as follows:

"(a) The debts to have priority, in advance of the payment of dividends to creditors, and to be paid in full out of bankrupt estates, and order of payment shall be (1) the costs and expenses of administration, *** (2) wages and commissions, *** (3) where the confirmation of an arrangement or wage - earner plan or the bankrupt's discharge has been refused, revoked, or set aside upon the objection and through the efforts and at the cost and expense of one or more creditors , or, where through the efforts and at the cost and expense of one or more creditors, evidence shall have been adduced resulting in the conviction of any person of an offense under chapter 9 of Title 18, the reasonable costs and expensed of such creditors in obtaining such refusal, revocation, or setting aside, or in adducing such evidence; (4) taxes which are not released by a discharge in bankrupt to the United States or to any State or any subdivision thereof which are not released by a discharge in bankruptcy *** (5) debts other than for taxes owing to any person, including the United States, who by the laws of the United States, is entitled to priority ***." (Emphasis added.)

It is clear from 31 U. S. C. 191 that I cases of debtor insolvency where the debtor commits an act of bankruptcy or makes a voluntary assignment of property, 31 U. S. C. 191 applies to give the Government first priority over general

creditors in the satisfaction of its claims. Lakeshore Apartments, Inc. v United States, 351 F. 2d 349 (1965); Hofmann v. United Welding and Mfg. Co., 102 A. 2d 878 (1954).

However, it should be noted that section 191 does not create a lien in favor of the Government but only a general priority, United States v. Haddix & Sons, Inc., 252 F. Supp. 634 (1966), and that the lower court have thus far held that the unsecured priority claims of the United States apply only as against debts not secured by specific and perfected liens and are subordinate to all such prior completed and perfected liens against the debtors property. United States v. Guaranty Trust Co. of New York, 33 F. 2d 533 (1929); United States v. Fidelity & Deposit Co. of Maryland, 214 F. 2d 565 (1954); United States v. Atlantic Municipal Corp., 212 F. 2d 709 (1954): United States v. State, 87 S. E. 2d 577 (1955). The Supreme Court has not yet decided whether a specific and perfected lien must be accorded priority against the Federal Government under 31 U. S. C. 191. United States v. Gilbert Associates, 345 U. S. 361, 365 (1953).

Further, section 191 is not applicable to proceedings in bankruptcy - as distinguished from reorganization proceedings - except in limited instances, and must yield in such proceeding to the distribution scheme of the Bankruptcy Act. United States v. Gargill, 218 F. 2d 556 (1955).

Under section 64a of the Bankruptcy Act, 11 U. S. C. 104 (a) (5), debts owing the United States, other than for taxes, are accorded the fifth and lowest priority of the distribution scheme, after administrative costs, wage claims, State and Federal taxes, etc. See general 8 A. C. J. S. Bankruptcy, section 458. Also, it would appear that under section 64 the rights of the United States as an unsecured creditor would be subordinate not only to the first four priorities among unsecured creditors but also to all holders of perfected liens, as in the case of insolvent debtors under 31 U. S. C. 191. In Re Quaker City Uniform Co., 238 F. 2d 155 (1956, cert. Den. 352 U. S. 1030.

In the context of the proposed Penn Central loan guarantee, it should be noted that a railroad is not entitled to the benefits of the Bankruptcy Act (title 11, United States Code), as a voluntary bankrupt, nor may a railroad be adjudged an involuntary bankrupt. 11 U. S. C. 22. However, section 77 of the Bankruptcy Act (11 U. S. C. 205) provides for the reorganization of railroads (if insolvent or unable to meet debts as they mature) at the request of either the railroad, a subsidiary, or creditor.

Subsection (b) of section 77 provides that a plan for reorganization shall include provisions modifying or altering the rights of creditors generally, or any class of them, secured or unsecured. Subsection (e) provides, in part that (quoting from the Code):

"* * * If the United States of America, or any agency thereof, or any corporation (other than the Reconstruction Finance Corporation) the majority of the stock of which is owned by the United States of America, is a creditor or stockholder, the interest or claims thereof shall be deemed to be affected by the plan, and the President of the United States, or any officer or agency he may designate, is authorized to act in respect of the interests or claims of the United States or of such agency or other corporation. * * *

"* * * Provided further, That if, in any reorganization proceeding under this section, the United States is a creditor on claims for taxes or customs duties

(whether or not the United States has any other interest in, or claim against, the debtor, as creditor or stockholder), no plan which does not provide for the payment thereof shall be confirmed by the judge exempt upon the acceptance, certified to the court, of a lesser amount by the President of the United States or the officer or agency designated by him pursuant to the provisions of the preceding paragraph hereof ***." (Emphasis added.)

Also, section 77 (1) (11 U. S. C. 205 (1)), provides as follows:

"In proceedings under this section and consistent with the provisions thereof, the jurisdiction and powers of the court, the duties of the debtor and the rights and liabilities of creditors, and of all persons with respect to the debtor and its property, shall be the same as if a voluntary petition for adjudication had been filed and a decree when the debtor's petition was filed."

It is stated in Collier on bankruptcy that the exact application and effect of section 77 (1) is not always apparent and in some instances is exceedingly obscure, since section 77 as a whole is such a wide departure from the usual bankruptcy law and practice, and the purpose of section 77 is conservation and rehabilitation rather than liquidation. See section 77.10, Collier on Bankruptcy, 14th Edition. Collier states further that it is extremely doubtful that section 64 (governing priorities in ordinary bankruptcy) can be considered generally applicable to section 77 proceeding. See section 77.21.

If section 64 (a) of the bankruptcy Act be considered as not controlling priorities in a section 77 proceeding, then a court might hold 31 U. S. C. 191 applicable thereto, subject, of course, to any priorities provided for by section 77 Cf. In this connection United States in this connection United States v. Anderson, 334 F. 26 111 (1964), where the court held that the general statute (31 U. S. C. 191) giving the United States priority whenever any person indebted to the United States is insolvent was operative to give all debts due the United States is insolvent was operative to give all debts due the United States priority in a chapter X (of the Bankruptcy Act, 11 U. S. C. 501-676) reorganization proceeding, and that the United States was not limited to priority in such proceedings for only its claims for taxes and customs duties. United States v. Anderson, 334 F. 2d 11 (1964), cert. Denied, 379 U. S. 879.

In view of the above, it appears that the United States, once having performed its obligations as a loan guarantor under section 301 of the Defense Production Act of 1950, would not, except in relation to general creditors in cases of insolvency under 31 U. S. C. 191, assume a senior position vis-a-via other creditors of the assisted company, in the absence of an agreement form prior creditors that their claims will be subordinate to those of the United States.

Concerning the basic legality of the proposed loan guarantee, while section 301 of the Defense Production Act may have been intended primarily to assist small and medium-sized defense contractors, the language used in section 301 is very broad and provides for the guarantee of loans to Government contractors, subcontractors, or "other person in connection with the performance of any contract or other operation deemed by the guaranteeing agency to be necessary to expedite production and deliveries or services under Government contracts for the procurement of materials or the performance of services for the national defense." Thus the language of section 301 does not limit assistance thereunder to small and medium - sized defense contractors. Also, in 96 Cong. Rec. 12864-65, it is made clear that the "services" referred to include

transportation services.

Further, the legislative history of section 301 indicates that while the particular concern was to assist and encourage small and medium - sized defense contractors, it was not necessarily intended to be restricted to such contractors but could include large - size defense contractors. In this connection note the following statements form R. Rept. No. 2759, 81st Cong., 2d sess., on the bill which become the Defense Production Act of 1950:

"Section 301 of the bill would authorize the President to reinstate a guaranty program similar to the V-loan program operated by the Federal Reserve System during World War II. The proposed program would be confined to the guaranty by the national defense procurement agencies of loans made by banks and other financial institutions to contractors to finance the production of defense materials needed by the United States in the present emergency.

"The financing problems of contractors engaged in defense production, particularly where they are small and medium size, are unique in character. * * *

"During the course of the V- loan program, bank loans to war contractors, both large and small, amounting to about $10 1/2 billion were approved for guaranties. Over 90 percent of the number and one - third of the amount of these guaranties were on loans to small and medium - size businesses; that is businesses with total assets of less than $5 million. ***" (Emphasis added.)

In light of the foregoing, we would not question the legality of the proposed loan guarantee.

In reference to the fact that DOD may not have made loan guarantees in the past without prior certification of essentiality for defense purposes from the OEP, we find no requirement under present Federal Law or OEP regulation necessitating such prior certification by the OEP in connection with section 301 loans. Also we have been informally advised by a representative of OEP that it has not been OEP's general practice to certify to the essentiality of loan for section 301 purposes.

We made no determination as to the need for, or advisability of, undertaking such a commitment, since the guarantee has not and apparently will not be make.

We trust this information is responsive to your request.

Sincerely yours,

(SIGNED) ELMER B. STAATS Comptroller General of the United States