

The Government Taketh: Application of the Federal Payment Levy Program to Medicare Receivables and How Lenders Can Protect Themselves

By

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I. Introduction

Effective October 1, 2008, the Centers for Medicare and Medicaid Services (“CMS”) implemented the Federal Payment Levy Program (“FPLP”) of the Department of Treasury. This program allows CMS to deduct up to fifteen percent from Medicare Part A and B payments to health care providers and suppliers to offset any federal tax delinquency. Because of the potentially negative impacts this program may have on unaware lenders, court-appointed receivers and bankruptcy trustees, this article explains how the program functions, how courts will likely address priority issues concerning the levy and lenders’ security interests in Medicare payments, and what lenders can do to protect their interests going forward.

II. CMS Implementation of FPLP

The Taxpayer Relief Act of 1997¹ originally authorized the FPLP, which came to be codified in Internal Revenue Code section 6331(h). Under the Act, the Secretary of the Treasury may continuously levy “up to 15 percent of any specified payment due to the taxpayer.”² The Act includes Medicare Payments in the definition of “specified payment.”³ The IRS began employing the FPLP in 2000,⁴ and CMS began applying the program to Medicare Part C payments in 2001.⁵ However, CMS has not attempted to apply the program to Medicare Part A and B payments until July of this year, when it announced it would do so in proposed

¹ Pub. L. No. 105-34, 111 Stat. 923 (Aug. 5, 1997).

² I.R.C. § 6331(h)(1) (2000).

³ See I.R.C. § 6331(h)(2)(A) (2000) (levy includes all federal payments, except those based on need or income).

⁴ Medicare Program; Revisions to Payment Policies under the Physician Fee Schedule, 73 Fed. Reg. 38502, 38536-38537 (July 7, 2008).

⁵ *Id.* at 38537.

rulemaking.⁶ In the same publication, CMS solicited comments on whether CMS should amend its regulations to allow it to revoke billing privileges for individuals receiving Medicare payments that for some reason cannot be reached by the FPLP. CMS indicated that it would not adopt such a regulation until after implementation and analysis of the FPLP process.⁷

Since giving the notice above, CMS has moved rapidly to implement the FPLP. On August 15, 2008, CMS issued a notification to providers informing them that effective October 1, 2008, CMS would begin reducing Medicare payments to providers by the statutory amounts if those providers owed overdue federal taxes.⁸ Presently, the program is in full effect.

III. Law Governing Government Offsets

No court has yet determined the rights of a lender with a security interest in federal payments subject to the FPLP. As discussed below, given the opportunity, a court may construe the FPLP as a valid setoff between the debtor and the United States Government. Consequently, lenders may find their interests subordinated to the setoff rights of the government.

A. The United States Government as a Unitary Creditor

Though the deduction under the FPLP is characterized as a levy, it is likely to be construed as a setoff. According to the Supreme Court, “The right of setoff (also called ‘offset’) allows entities that owe each other money to apply their mutual debts against each other, thereby avoiding ‘the absurdity of making A pay B when B owes A.’”⁹ Additionally, the Supreme Court has held that “[t]he government has the same right ‘which belongs to every creditor, to apply the

⁶ *Id.*

⁷ *Id.*

⁸ CMS, Reporting Withholding Due to IRS Federal Payment Levy Program (FPLP) on the Remittance Advice, MLN Matters No. MM6125 (Aug. 15, 2008), *available at* <http://www.cms.hhs.gov/MLNMattersArticles/2008MMAN/itemdetail.asp?filterType=none&filterByDID=-99&sortByDID=8&sortOrder=ascending&itemID=CMS1214359&intNumPerPage=10>.

⁹ *Citizens Bank v. Strupf*, 516 U.S. 16, 17 (1995) (quoting *Studley v. Boyston Nat’l Bank*, 229 U.S. 523 (1913)).

unappropriated moneys of his debtor, in his hands, in extinguishment of the debts due to him.”¹⁰ This statement, however, seems to break down when one of the entities is the federal government, particularly in the situation governed by the recent application of the FPLP to the CMS. How is it that the one government agency may offset from payments to an individual the debt the individual owes to another separate agency?

The Court of Appeals for the Tenth Circuit answered this question in *In re Turner*.¹¹ *Turner* addressed the issue of whether, in the context of bankruptcy proceedings, different United States agencies should be treated as different entities, and thus not entitled to setoff rights.¹² The court said no.¹³ In its analysis, the court first determined that outside of bankruptcy, “the United States is treated as a unitary creditor, and agencies . . . may set off debts owed by one agency against claims that another agency has against a single debtor.”¹⁴ In support of this statement, the *Turner* court cited a statute, 31 U.S.C. § 3716(a), which authorizes administrative offsets between agencies,¹⁵ and a Supreme Court case, *Cherry Cotton Mills v. United States*,¹⁶ which indicated in dicta that separate agencies may exercise the right of setoff when dealing with a single debtor.¹⁷

Turner then addressed whether a bankruptcy filing would change the United States government’s unitary status, and held that such an action would not.¹⁸ The court noted, first, that Bankruptcy Code section 553¹⁹ preserved the rights of setoff otherwise existing outside of

¹⁰ *United States v. Munsey Trust Co.*, 322 U.S. 234 (1947) (quoting *Gratiot v. United States*, 40 U.S. (Pet.) 336 (1841)).

¹¹ 84 F.3d 1294 (10th Cir. 1996) (*en banc*).

¹² *Turner*, 84 F.3d at 1297.

¹³ *Id.*

¹⁴ *Id.* at 1296.

¹⁵ 31 U.S.C. § 3716(a) (Supp. 2006).

¹⁶ 327 U.S. 536 (1946).

¹⁷ *Turner*, 84 F.3d at 1296-1297 (quoting *Cherry Cotton Mills*, 327 U.S. at 539).

¹⁸ *Turner*, 84 F.3d. at 1297.

¹⁹ 11 U.S.C. § 553 (Supp. 2006).

bankruptcy.²⁰ Second, the court relied on one of its own Tenth Circuit precedents, *Luther v. United States*,²¹ as well as a recently decided case from the Ninth Circuit, *Doe v. United States*,²² both of which held that the United States, for purposes of setoff, was a unitary creditor in a bankruptcy proceeding.²³ Because the agencies would be treated as one creditor outside of bankruptcy and because the majority of cases addressing the issue considered the agencies unitary and capable of setoff in bankruptcy, the *Turner* court concluded that the government could offset the debtor's debts to one agency against the claims from another.²⁴

B. Priority of the Government's Setoff Rights

Not only do courts consider separate government agencies as unitary for the purposes of setoff, but courts also have held that the government's setoff rights have priority over existing assignments or liens in bankruptcy. The Uniform Commercial Code would seem to support the government should it assert that its setoff rights have priority over other secured parties.²⁵ Additionally, as noted above, Bankruptcy Code section 553 does not affect a creditor's setoff rights.²⁶ These sources indicate that when the government does have a right of setoff, it may be able to exercise it to the detriment of other secured parties.

²⁰ *Turner*, 84 F.3d at 1297-1298.

²¹ 225 F.2d 495 (10th Cir. 1954)

²² 58 F.3d 494 (9th Cir. 1995).

²³ *Luther*, 225 F.2d at 498; *Doe*, 58 F.3d at 498.

²⁴ *Turner*, 84 F.3d at 1298; *see also* *United States v. Maxwell*, 157 F.3d 1099 (7th Cir. 1998); *cf. In re Doctors Hosp. of Hyde Park, Inc.*, 337 F.3d 951 (7th Cir. 2003) (holding that Illinois state health agency may offset state Medicare payments against outstanding state taxes).

²⁵ *See* UCC § 9-109(d)(10) ("This article does not apply to: . . . a right of recoupment or set-off."). However, some courts still apply the UCC priority rules to setoffs. *See* *MNC Commercial Corp. v. Joseph T. Ryerson & Son, Inc.*, 882 F.2d 615 (2d Cir. 1989); *Pioneer Commercial Funding Corp. v. United Airlines, Inc.*, 122 B.R. 871 (S.D.N.Y. 1991); *Cont'l Am. Life Ins. Co. v. Griffin*, 306 S.E.2d 285 (Ga. 1983); *Bank of Kansas v. Hutchinson Health Servs., Inc.*, 735 P.2d 256 (Kan. Ct. App. 1987); *Se. Fin. Corp. v. Nat'l Bank of Detroit*, 377 N.W.2d 900 (Mich. Ct. App. 1985).

²⁶ 11 U.S.C. § 553(a).

For instance, in *In re Nuclear Imaging Systems, Inc.*,²⁷ the government moved to lift the automatic stay to offset the debtor's debt to the IRS with Medicare payments owed to the debtor in which a private creditor had a security interest.²⁸ After first finding that the federal government was a unitary creditor in bankruptcy for setoff purposes,²⁹ the court then considered whether the United States had priority over the creditor's interest in the Medicare receivables.³⁰

The bankruptcy court first determined that the Pennsylvania UCC applied to government setoff claims, instead of the common law, and that the government would not have priority over all secured creditors if the setoff claim arose after 1) the security interest was perfected, and 2) the secured creditor gave actual notice, not just constructive notice by filing financing statements, to the government of its interest.³¹ In the case, the creditor did not give actual notice to the government and thus did not have priority and could not block the government's attempt to lift the automatic stay and collect its debt.³²

Contrast the holding in *Nuclear Imaging* with *In re Alliance Health of Forth Worth, Inc.*³³ In that case, the United States District Court for the Northern District of Texas held that the creditor's security interest in the debtor/hospital's Medicare payments did not receive any rights greater than the debtor and thus did not have priority over government's setoff rights.³⁴ Alternatively, the court held that the creditor would still not have priority under the UCC, even if

²⁷ 260 B.R. 724 (Bankr. E.D. Pa. 2000).

²⁸ *Nuclear Imaging*, 260 B.R. at 728-729.

²⁹ *Id.* at 733-734.

³⁰ *Id.* at 741

³¹ *Id.* at 742-743 (citing unrevised version of UCC § 9-318(a) (1952)).

³² *Nuclear Imaging*, 260 B.R. at 744-745; see also *Maxwell*, 157 F.3d at 1101, 1103 (holding that the entire amount of a payment owed by the Navy to the debtor for contract work could be used to set off debts owed by the debtor to the Small Business Administration, despite the fact that subcontractors of the debtor claimed an equitable lien in the payments).

³³ 240 B.R. 699 (N.D. Tex. 1999).

³⁴ *Id.* at 704.

it did apply, for the same reasons given in *Nuclear Imaging*.³⁵ Thus, depending on the jurisdiction, a secured creditor may have priority over a government setoff claim if the creditor is first in time, may be required to give actual notice of its interest in order to have priority, or may not have priority regardless of any steps the creditor may take.

IV. Practical Implications

As evidenced by the discussion above, when confronted with an issue related to the latest implementation of the FPLP to Medicare payments, a court is likely to conclude, first, that because the government is a unitary creditor both inside and outside of bankruptcy, the program, which requires one agency, CMS, to pay tax debts owed by a Medicare recipient to another agency, IRS, before paying the recipient, is a valid setoff. Second, depending on the jurisdiction, the court could then conclude 1) that a perfected security interest that is first in time has priority over the government's setoff; 2) that a perfected security interest that is first in time has priority over the government's setoff only if the secured creditor has given actual notice of the interest to the government; or 3) that a perfected security interest will not have priority over the government's setoff.

Given these possibilities, a lender planning to take a security interest in Medicare receivables should take the following steps to protect that interest. First, the lender should investigate whether the debtor has any outstanding tax debt and if so should either 1) require payment of that debt before lending or 2) insist on higher financing charges to compensate for the increased risk associated with potential loss of collateral. Second, a lender should give actual notice to CMS, preferably in writing, of any interest in Medicare receivables the lender has taken. Depending on the jurisdiction, these steps may prevent the lender from losing a priority fight with the U.S. government.

³⁵ *Id.* (citing unrevised version of UCC § 9-318(a) (1952)).