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1956

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### Recommended Citation

Malcolm C. Douglas, *Federal Liens Versus State Liens--A Problem in Priorities*, 8 W. Rsrv. L. Rev. 89 (1956)  
Available at: <https://scholarlycommons.law.case.edu/caselrev/vol8/iss1/10>

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ages could have restored the status quo so as to permit the plaintiff his true and effective remedy. In this way, at least to the extent of the doctrine of election between remedies, modern courts can and should free themselves of rule from the grave.

WILLIAM TOUSLEY SMITH

## *Federal Liens Versus State Liens—A Problem In Priorities*

### INTRODUCTION

The problem posed by any determination of the relative priority of state and federal tax liens to the proceeds from a foreclosure sale is an integral part of the overall conflict between the interests of the state and federal governments. Each taxing unit attempts to obtain preference for its claims and logical arguments based on statute, precedent and policy are available to each contestant. State authorities argue that the operations of local government will be impaired if the federal government preempts the funds upon which local government is dependent for support,<sup>1</sup> while the federal government may point to authoritative precedent favoring its demands and to the economic necessity for its assertion of its tax liens. The controversy is further confused when antecedent mortgagees and judgment creditors assert claims against the property under foreclosure.

The courts have done little to clarify the situation and one studying the cases will find only confusion, hedging and inconsistency.

In discussing this problem, one must first turn to the two statutes which grant rights of priority to the federal government, and to the cases which have construed these enactments. Section 3466 of the Revised Statutes<sup>2</sup> grants to the federal government a first priority against the assets of an insolvent debtor. This statute does not create a lien, but rather gives the government a statutory preference which attaches when the property of the insolvent passes into the hands of a third person for the benefit of creditors.<sup>3</sup> This priority covers all debts due the federal gov-

<sup>1</sup> In *Southern Ohio Savings Bank & Trust Co. v. Bolce*, 165 Ohio St. 201 (1956), the court itself pointed out that this was a major policy reason favoring the priority of state tax liens.

<sup>2</sup> REV. STAT. § 3466 (1875), 31 U.S.C. § 191 (1946) states in part as follows: "Whenever any person indebted to the United States is insolvent or whenever the estate of any deceased debtor in the hands of executors or administrators, is insufficient to pay all the debts due from the deceased, the debts due the United States shall first be satisfied."

<sup>3</sup> *United States v. Fisher*, 6 U.S. (2 Cranch) 358 (1804).

ernment, thereby including within its scope taxes due the United States.<sup>4</sup> The other statute which will be discussed is Section 6321 of the Internal Revenue Code<sup>5</sup> which creates a lien on all the property of a delinquent taxpayer, but is applicable only to tax debts.

#### SECTION 3466

The priority created by Section 3466 was probably intended to apply only to the unencumbered property of the insolvent debtor<sup>6</sup> and the early cases construing this statute held that antedating equitable liens were superior to the priority granted the federal government.<sup>7</sup> But in the leading case of *Spokane County v. United States*,<sup>8</sup> the United States Supreme Court promulgated what has been labeled the doctrine of the "inchoate lien," by which the federal priority is held to defeat an antedating state lien which is not specific or perfected. A lien is not perfected or choate unless (1) the identity of the lienor, (2) the property subject to the lien, and (3) the amount of the lien are all established.<sup>9</sup>

In the *Spokane County* case, state taxes had been assessed prior to the attaching of the federal priority. The court held, however, that as there had been no distraint leveled against the taxpayer's property, the specific property subject to the lien was not established and the lien, therefore, had not been perfected. The court reserved the question of what its determination would have been had the state lien been perfected by distraint.

In *New York v. Maclay*,<sup>10</sup> the claim of the state of New York was for taxes due before the attaching of the federal preference, but neither assessed nor liquidated until after the federal preference had attached. Under state law, these taxes constituted a lien in the sense that they took precedence by relation over intervening claims. The court held that the doctrine of relation could not divest the United States of the preference that accrued when receivers were appointed and its preference thereby

<sup>4</sup> *Price v. United States*, 269 U.S. 492 (1926)

<sup>5</sup> INT. REV. CODE OF 1954, § 6321 states that "If any person liable to pay any tax neglects or refuses to pay the same after demand, the amount shall be a lien in favor of the United States upon all property and rights to property, whether real or personal, belonging to such person."

<sup>6</sup> *Kennedy, The Relative Priority of the Federal Government*, 63 YALE L. J. 905 (1954).

<sup>7</sup> *Brent v. Bank of Washington*, 35 U.S. (10 Pet.) 596 (1836); *United States v. Hack*, 33 U.S. (8 Pet.) 271 (1834); *Conrad v. Pacific Ins. Co.*, 31 U.S. (6 Pet.) 262 (1832); *Conard v. Nicoll*, 29 U.S. (4 Pet.) 291 (1830); *Conard v. Atlantic Ins. Co.*, 26 U.S. (1 Pet.) 386 (1828).

<sup>8</sup> 279 U.S. 80 (1929).

<sup>9</sup> *United States v. City of New Britain*, 347 U.S. 81 (1954).

<sup>10</sup> 288 U.S. 290 (1933).

attached. Thus, the state's lien was held to be inchoate or, in the words of the court, "merely the caveat of a more perfect lien to come."<sup>11</sup>

The case of *United States v. Waddill, Holland & Flinn, Inc.*<sup>12</sup> provides another excellent example of the Supreme Court's treatment of problems arising under Section 3466. Virginia, by statute, gave landlords a lien for rent due on all personal property of the tenant found on the leased premises.<sup>13</sup> The Virginia Supreme Court of Appeals had held that a landlord's statutory lien for rent due was fixed and specific, existing independently of the rights of distress and attachment, which were held to be merely methods of enforcing the lien.<sup>14</sup> However, the United States Supreme Court ruled that the lien gave the landlord only a general power over unspecified property. It was held that not until the landlord had made the extent of his lien known and had taken some step to attach sufficient property to satisfy the lien could it be possible to specify the amount of the lien or the goods subject to the lien. Thus the fact that the landlord had not actually asserted his lien was held to have rendered that lien inchoate. The court also pointed out that it is a matter of federal law as to whether a lien created by a state statute is sufficiently specific and perfected to raise questions concerning the applicability of the priority given the claims of the federal government by Section 3466.

In *Illinois ex rel Gordon v. Campbell*,<sup>15</sup> the Supreme Court held that the recording of a statutory lien does not exclude property subject to the lien from the operation of the federal priority, although under state law the record of the lien constituted constructive notice to all subsequent claimants. The state's lien was for unemployment compensation contributions and attached to all the personal property of the employer used in his business.<sup>16</sup> The court held that the statutory language "all the personal property used in the business" was too comprehensive to allow proper identification of the property subject to the lien. The lien was therefore held to be inchoate.

The Supreme Court, by maintaining seemingly unattainable standards of choateness has managed to avoid the question of whether Section 3466 grants the United States priority against a specific and perfected lien, thus leaving the law in this area uncertain.

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<sup>11</sup> *Ibid.*

<sup>12</sup> 323 U.S. 353 (1945).

<sup>13</sup> CODE OF VIRGINIA OF 1950 § 55-227, § 55-231.

<sup>14</sup> *United States v. Waddill, Holland & Flinn Inc.*, 182 Va. 351, 28 S.E.2d 741 (1944).

<sup>15</sup> 329 U.S. 362 (1946).

<sup>16</sup> SMITH-HURD ANN. ST. CH. 48, § 243 (a) (1950).

## SECTION 6321

Section 6321 of the Internal Revenue Code establishes two different tests of priority for the tax lien. As against a mortgagee, pledgee, purchaser or judgment creditor, the priority of the tax lien dates from the time that notice of the lien is filed,<sup>17</sup> while as against all other creditors and lienors, the tax lien has priority from the time of its assessment.<sup>18</sup> The traditional judicial approach under this section has been that of "first in time, first in right."<sup>19</sup> But in *United States v. Security Trust and Savings Bank*,<sup>20</sup> the Supreme Court for the first time applied the doctrine of the "inchoate lien" to a situation arising under the tax lien statute. In the *Security Trust and Savings* case, a federal tax lien was recorded subsequent to an attachment lien, but prior to the date the attaching creditor obtained judgment. The court held that the attachment lien was "contingent or inchoate," that it was merely a *lis pendens* notice that a right to perfect the lien existed.

But in *United States v. City of New Britain*,<sup>21</sup> the court found a city lien for real property taxes specific and choate. The lien having been held choate, the court applied the doctrine of "first in time, first in right." This case cannot be reconciled with those cases under Section 3466 which have required that liens similar to that held by the City of New Britain be completed by distraint, nor is the identity of the lienor, amount of the lien, or property subject to the lien any better established by this lien than by the attachment lien in the *Security Trust and Savings* case.

The most recent case arising under Section 6321 is *United States v. White Bear Brewing Co.*<sup>22</sup> in which a mechanic's lien had been recorded for a specific amount and suit instituted prior to the assessment of the federal taxes and recording of the tax lien. In addition, the state lien had been reduced to judgment, the real estate sold at public auction and transferred by the purchaser to another prior to the filing by the United States of its action to foreclose the tax lien. However, in spite of these factors, the federal tax lien was held to take priority over the mechanic's lien. As the decision in the *White Bear* case was rendered without written opinion one cannot be sure of its doctrinal basis. But viewed in the light of the earlier decisions of the Supreme Court, it seems probable that the state

<sup>17</sup> INT. REV. CODE OF 1954, § 6323.

<sup>18</sup> INT. REV. CODE OF 1954, § 6322.

<sup>19</sup> The classic statement of this doctrine appears in *Rankin & Schatzell v. Scott*, 25 U.S. (12 Wheat.) 177 (1827) in which the court stated: "The principle is believed to be universal, that a prior lien gives a prior claim which is entitled to prior satisfaction out of the subject it binds. "

<sup>20</sup> 340 U.S. 47 (1950).

<sup>21</sup> 347 U.S. 81 (1954).

<sup>22</sup> 350 U.S. 1010 (1956).

lien was a victim of the court's utilization of the inchoate lien doctrine. When compared with the city's lien in the *New Britain* case, this lien seems to possess the essential requisites necessary to render it choate, but it must also be noted that it is no more definite as to the identity of the lienor, amount of the lien, or property subject to the lien than was the attachment lien in the *Security Trust and Savings* case. Placed in what seems to be its proper context, the *White Bear* case belongs to the line of decisions beginning with *United States v. Spokane County* and is in contravention of the court's holding in the *New Britain* case.<sup>23</sup>

A further complication is added when the incumbrances to be paid from the proceeds of a foreclosure sale include not only state taxes and federal tax liens but also mortgage and judgment liens which antedate the federal tax lien. The problem faced by any court dealing with such a situation is that classic example of a distributive impasse in which A is prior to B, B prior to C, and C prior to A.<sup>24</sup> Where the claimants are (A) the federal government, (B) a state government, and (C) an antecedent mortgagee or judgment creditor, the respective priorities are as follows: (1) a federal tax lien will generally be given priority over a state tax lien; (2) state real estate taxes have priority over mortgages and judgments; and (3) mortgage and judgment liens recorded prior to a federal tax lien notice are given priority over the federal tax lien.<sup>25</sup>

A recent Ohio case<sup>26</sup> presented the exact problem outlined above, and for the first time the Ohio Supreme Court was faced with the necessity of seeking some solution to this problem. The court interpreted the previously discussed cases as giving the federal tax lien priority over state taxes, and then set forth the following formula for the distribution of the proceeds from a foreclosure sale: (1) to the extent that the proceeds from the sale are sufficient, a fund is to be set aside equal in amount to the creditor liens which are given preference over the federal tax liens; (2) from this fund, the state real estate taxes are to be paid first; (3) the remaining amount in the fund is to be paid to the preferred lien-holders; and (4) the balance of the proceeds are to be paid to the federal government on its tax liens.

This decision seems as reasonable as any other that might be proposed, yet it leaves certain problems unanswered and is likely to be subject to some criticism.

One significant problem would be posed if the fund set aside were not sufficient to pay the real estate taxes in full. Under Ohio law, real estate

<sup>23</sup> The dissenting opinion in the *White Bear* case points out the manner in which the holding in that case contradicts the principles set forth in the *New Britain* case.

<sup>24</sup> White, *A Problem in Priorities*, 25 Ohio L. Rep. 116 (1926).

<sup>25</sup> *Southern Ohio Savings Bank & Trust Co. v. Bolce*, 165 Ohio St. 201 (1956).

taxes run with the land and if not paid out of the proceeds of an ordinary foreclosure sale, they would continue to be a charge on the land.<sup>27</sup> Thus the purchaser at a mortgage foreclosure would take subject to any unpaid real estate taxes. However, in a tax foreclosure, any unpaid taxes probably would be abated under the provisions of section 5721.19 of the Ohio Revised Code.<sup>28</sup>

The principal criticism that can be leveled against this formula is that the preferred lien holder is subject to being squeezed out in spite of the preference given him by the federal tax lien statute. Its ultimate effect is to subject his rights to the demands of the two competing governmental units.

This decision should not be too severely criticized however, for the court's only alternative would be to place the state tax lien at the bottom of the distributive heap. The principal reason for the confused state of the law in this area lies in the failure of the United States Supreme Court to hand down clear and definitive decisions when dealing with the problem of the relative priority of state and federal liens. The Supreme Court has time and again refused to clarify this confusing problem, choosing rather to hide behind the doctrine of the inchoate lien. An area in need of certainty has for three decades been confused by a consistent policy of doctrinal deviousness.

#### CONCLUSION

The first step that should be taken to clarify this confused area of the law is the elimination or negation of the doctrine of the inchoate lien. One critic of that doctrine has pointed out that

the condemned category of the inchoate and general lien created by the court and continually enlarged to include practically every lien coming before it, has come to embrace practically every lien to be found in the American law. The court has always been successful in finding the feature of inchoateness.<sup>29</sup>

The adoption by statute or judicial decision of the rule set forth in the Bankruptcy Act, by which inchoate and statutory liens may be perfected after the filing of the bankruptcy petition, would be a logical substitution for the inchoate lien doctrine.<sup>30</sup>

<sup>27</sup> OHIO REV. CODE § 5719.01.

<sup>28</sup> OHIO REV. CODE § 5721.19 in setting forth the manner of disposition of the proceeds from a tax foreclosure sale states: "If the amount applicable to any taxes, assessments, penalties, interest, and charges is deficient, such taxes, assessments, penalties, interest, and charges shall be deemed satisfied."

<sup>29</sup> Kennedy, *The Relative Priority of the Federal Government*, 63 YALE L. J. 905 (1954).

<sup>30</sup> Bankruptcy Act § 67(b), 11 U.S.C. § 107(b) (1952) provides that "where liens are required to be perfected and arise but are not perfected before bankruptcy,

A second remedial step would be a strict application of the "first in time, first in right" test for the determination of the priorities of the various competing liens. In the *New Britain* case, the Supreme Court advocated the use of that test to determine the priority of state and federal liens, but added that "the United States is not concerned in whether the State receives its taxes prior to mortgagees and judgment creditors."<sup>31</sup> However, the "first in time" approach to the determination of priorities seems to be the fairest solution, a solution which offers a measure of protection to both mortgagees and judgment creditors, whose rights are now subject to being curtailed or divested by governmental preferences and priorities. This solution would certainly give effect to the statutory preference given mortgagees and judgment creditors by Section 6323 of the Internal Revenue Code.

An improvement in the present situation is needed, but viewed in the light of past judicial decisions, an early clarification of this problem is improbable.

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they may nevertheless be valid if perfected within the time permitted by and in accordance with the requirements" of the law creating them.

<sup>31</sup>United States v. City of New Britain, 347 U.S. 81 (1954).