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Does a Federal Tax Lien Take Priority over a Mortgagee's Lien on Rents?

Bloomfield State Bank v. United States

By R. Wilson Freyermuth

Suppose that Developer owns an office building subject to a recorded deed of trust and assignment of rents in favor of State Bank. The building is partially occupied by Tenant A, who is paying rent to Developer under a long-term lease entered into several years ago. Suppose further that two months ago, because of Developer's failure to pay income and payroll taxes, the Internal Revenue Service (IRS) filed a notice of tax lien against Developer in the appropriate filing office. Finally, suppose that just last week, Developer entered into a new lease for the remaining space in the building with Tenant B. As between State Bank and the IRS, which has priority for rents collected from Tenant A? From Tenant B?

Surprisingly, few reported cases have addressed the relative priority rights of a mortgage lender and the IRS for rents from real estate. In *Bloomfield State Bank v. United States*, No. 10-3939, 2011 WL 1773953 (7th Cir. May 11, 2011), Judge Richard Posner provided the first reported federal appellate opinion; under its analysis, State Bank would have priority over the IRS in the above hypothetical for the rents due from both tenants. This article discusses Judge Posner's opinion, both for its result (which the author believes is ultimately the correct result) and how it characterizes background principles of real estate finance law (as it turns out, not entirely correctly). Before getting to the opinion, however, this article begins with a brief primer on federal tax liens.

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The Federal Tax Lien Act

The Federal Tax Lien Act (FTLA) grants to the United States a lien on property belonging to a taxpayer that fails to pay federal taxes following proper demand. 26 U.S.C. § 6321. This lien relates back to the date on which the taxes became due, id. § 6322, and attaches to all existing and after-acquired real and personal property in which the taxpayer has an interest. Id. § 6321; Treas. Reg. § 301.6321-1. Because the lien arises by operation of law, it is a "secret lien" of which third parties dealing with the taxpayer may be unaware. Thus, the FTLA requires the IRS to file a public notice of the lien to make it effective against the rights of subsequent purchasers, judgment creditors, mechanics' lienholders, and holders of consensual security interests. 26 U.S.C. § 6323(a).

The first-in-time principle provides the baseline for determining the priority of conflicting property interests, including federal tax liens. There are circumstances, however, in which a federal tax lien may take priority over a conflicting first-in-time lien. One such circumstance involves an unperfected security interest. A security interest arising under state law is deemed to exist for FTLA purposes only if the collateral is "in existence" and the interest "has become protected under local law against a subsequent judgment lien arising out of an unsecured obligation." 26 U.S.C. § 6323(h)(1)(A). Thus, for example, the holder of an unperfected Article 9 security interest—whose claim is subordinate to a judgment lien creditor under UCC § 9-317(a)(2)(A)—would have no "security interest" within the meaning of the FTLA, and thus would be subordinate to a later-filed federal tax lien. By contrast, the priority of an unrecorded real estate mortgage would depend on the state's recording statute. If that statute requires recording to make a mortgage effective as against later judgment creditors, the holder of an unrecorded mortgage would have no "security interest" within the meaning of the FTLA and would be subordinate to a later-filed federal tax lien. See, e.g., *Citizens State Bank v. United States*, 932 F.2d 490 (6th Cir. 1991) (applying Kentucky law). In many states, however, even an unrecorded mortgage is effective against judgment creditors, and in those states an unrecorded mortgage would still have priority against a later-filed federal tax lien. See, e.g., 11 *Thompson on Real Property* § 92.09(b)(6) (2d Thomas ed. 2002) (noting the variation among state recording statutes in protecting judgment creditors).

The second circumstance involves the headache-inducing "choateness" doctrine. Even if a secured party has properly perfected a security interest

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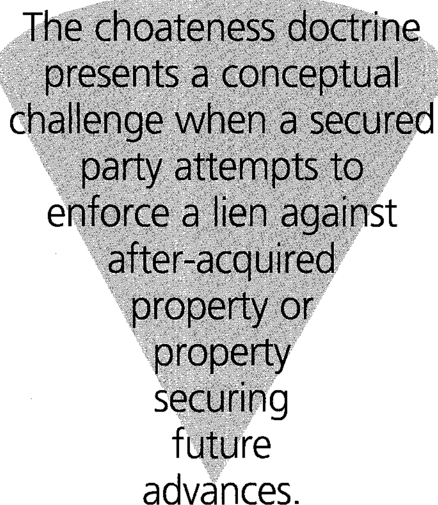
before the government files notice of its tax lien, the secured party will not have priority over the tax lien unless its security interest is "choate." As explained in *United States v. McDermott*, 507 U.S. 447 (1993), a security interest is choate if the identity of the secured party, the property to which the interest attaches, and the amount of the debt are all "established." In a typical residential mortgage transaction involving a single mortgage loan and a security interest in the borrower's home, choateness is clear, and thus a properly recorded mortgage lien will have priority over a later-arising federal tax lien.

The choateness doctrine presents a conceptual challenge when a secured party attempts to enforce a lien against after-acquired property or property securing future advances. For example, suppose that First Bank holds a properly perfected security interest in all of the present and after-acquired accounts receivable of Joe's Plumbing, against which the IRS has just filed a tax lien notice. Suppose further that over the ensuing six months, Joe's Plumbing performs a number of jobs for its customers on account, under which Joe's is entitled to be paid a total of $20,000. UCC Article 9 certainly permits a debtor like Joe's Plumbing to grant a security interest in after-acquired property. UCC § 9-204(a). But the $20,000 worth of accounts receivable at issue did not legally exist until Joe's Plumbing did the work and the customers became liable for payment—which, in this scenario, occurred only after the IRS filed its tax lien notice. In tax-speak, these accounts receivable were "inchoate" (that is, not in existence) at the time the IRS filed its tax lien notice. As a result, First Bank's prior-perfected security interest in these particular accounts would not take priority over the tax lien, except to the limited extent provided in FTLA § 6323(c) (which would apply only to accounts that arose within 45 days after the tax lien filing, and only to the extent such accounts secured sums advanced before the tax lien filing or within 45 days after that filing and without actual notice or knowledge of the filing). See, e.g., *J.D. Court, Inc. v. United States*, 712 F.2d 258 (7th Cir. 1983).

Rents and the Federal Tax Lien: Like Accounts, or Not?

Before its revision, Article 9 defined "account" as a right to payment "for goods sold or leased or for services rendered." UCC § 9-106 (1972 text). Revised Article 9, however, expanded the definition of account to include "a right to payment of a monetary obligation . . . for *property* that has been or is



to be sold, leased, licensed, assigned, or otherwise disposed of." UCC § 9-102(a)(2)(i) (emphasis added). By replacing "goods" with "property," Article 9 expanded the definition of accounts to include payment rights resulting from contracts for the sale of intellectual property and real estate. As a result, the right to collect rents under a lease of land technically constitutes an "account" within the meaning of Article 9.

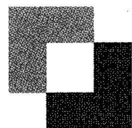
This change in Article 9 did not have any effect on documentation practices for mortgage lending. Revised Article 9 still contains a scope limitation that excludes from its coverage transactions involving "the creation or transfer of an interest in or lien on real property, including a lease or rents thereunder." UCC § 9-109(d)(11). Thus, a mortgagee must create a lien on rents by taking and recording an assignment of rents in the real property records, either directly in the mortgage itself or in a separate document, rather than by using the Article 9 mechanisms of attachment and perfection.

As discussed in the previous section, courts have generally held that under the choateness doctrine, a federal tax lien will have priority for accounts arising after the filing of a tax lien notice (with limited exceptions). This creates a potential concern for mortgage lenders claiming a lien against rents arising from the mortgaged land: how does the choateness doctrine apply to such rents? Because those rents are literally "accounts," should the IRS have priority for rents collected after the IRS filed its tax lien notice?

In some circumstances, the answer is relatively clear. For example, return to the hypothetical posed in the introduction. Developer's right to collect rents accruing under Tenant A's lease came "into existence" within the meaning of the choateness doctrine on the signing of the lease—before the IRS obtained its tax lien—even if Developer cannot take legal action to collect any specific rental payment until it actually accrues. Because State Bank holds a prior recorded assignment of rents, and the right to collect rents under the lease came into existence before the IRS filed its notice of tax lien, State Bank has priority over the IRS for those rents.

But what about the rents accruing under Tenant B's lease? Tenant B's lease did not come into existence until after the IRS filed its tax lien notice. In this situation, can the IRS successfully argue that the choateness doctrine is not satisfied and that the IRS thus has priority for rents arising under Tenant B's lease?

Until recently, this issue had generated only two lower court opinions, neither printed in official reporters. In *First National Bank of Ohio v. United States*, No. 5:90CV1984, 1994 WL 481357 (N.D. Ohio, Mar. 28, 1994), the court ruled for the IRS, analogizing the rents arising after the tax lien filing to after-acquired accounts. By contrast, in *Bank One, West Virginia, N.A. v. United States*, No. A.3:93-1053, 1996 WL 303276 (S.D. W. Va. Mar. 29, 1996), the court ruled in favor of the mortgagee, concluding that the IRS wrongfully levied on rents arising under a sublease entered into after the IRS filed its tax lien notice. *Bloomfield State Bank v. United States* provides the first reported appellate



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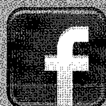

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opinion addressing the issue. Although *Bloomfield State Bank* properly resolved the dispute in favor of the mortgagee, its language and reasoning in reaching this conclusion bear close scrutiny.

The *Bloomfield State Bank* Case

In 2004, Bloomfield State Bank (Bloomfield) obtained and recorded a mortgage and assignment of rents on the borrower's land. In 2007, the borrower defaulted, and the IRS filed a notice of tax lien against the land. At some point, Bloomfield obtained the appointment of a receiver for the land pending foreclosure, and the receiver successfully leased a portion of the mortgaged premises, collecting a total of $82,675 in rents. When the IRS claimed that its tax lien took priority over Bloomfield's lien in these rents, Bloomfield filed an action in the U.S. District Court for the Southern District of Indiana seeking a judgment declaring that Bloomfield's lien on the rents had priority.

Citing *First National Bank of Ohio,* the IRS argued that the rents had not come into existence until after the IRS filed its tax lien notice, entitling the IRS to priority. The district judge agreed, analogizing the rents to after-acquired accounts receivable and thus concluding that the result was controlled by the decision in *J.D. Court*, 712 F.2d 258:

> [*J.D. Court*] held that "a security interest in accounts receivable does not become 'choate' until the accounts receivable actually come into existence . . . at the time the services giving rise to the accounts receivable are performed." 712 F.2d at 263. The Court sees no reason why the Seventh Circuit would have reached a different result if the property at issue in *J.D. Court* were rental payments as opposed to accounts receivable.

Bloomfield State Bank v. United States, No. 2:10-cv-00131-LJM-WGH, 2010 WL 5640193 (S.D. Ind. Oct. 27, 2010). Bloomfield argued that this result was unsound because the loss of priority would discourage mortgagors and mortgagees from cooperating to lease vacant portions of distressed mortgaged premises once the IRS files a tax lien notice. The district judge acknowledged this but concluded:

> [S]uch reasoning would also apply to the accounts receivable at issue in *J.D. Court*, and the Court declines to assume the reasoning went overlooked by that court. Instead, the Seventh Circuit was persuaded by the important role that tax collection plays in our government. See *J.D. Court*, 712 F.2d at 263 ("[t]he importance of securing adequate revenues to discharge national obligations justifies the extraordinary priority accorded federal tax liens through the choateness and first-in-time doctrines").

When the IRS claimed that its tax lien took priority over Bloomfield's lien in these rents, Bloomfield filed an action in the U.S. District Court for the Southern District of Indiana seeking a judgment declaring that Bloomfield's lien on the rents had priority.

Id.

On appeal, the Seventh Circuit reversed, remanding the case for entry of a judgment declaring Bloomfield's priority over the IRS for the collected rents. In a brief yet characteristically colorful opinion, Judge Richard Posner argued that the IRS's "choateness" argument was misguided and rejected the notion that the rents were akin to after-acquired accounts receivable. In his view, the mortgaged land was in existence before the tax lien filing, and the rents were "proceeds" of the land without regard to the timing of the lease:

> The real estate that generated the rental income at issue in this case existed when the mortgage was issued and thus before the tax lien attached; the rental income was proceeds of that property, which preexisted the tax lien. . . .
>
> [B]ecause the bank had a lien on the real estate, the rentals were proceeds. By virtue of the rental-income provision in the mortgage [i.e., the assignment of rents], the bank had a separate lien on the rents, but that is not the lien on which it is relying to trump the tax lien. The lien on which it is relying is the lien on the real estate. If an asset that secures a loan is sold and a receivable generated, the receivable becomes the security, substituting for the original asset. The sort of receivable to which the statute denies priority over a federal tax lien is one that does not match an existing asset; a month's rent is a receivable that matches the value of the real property for that month.

Bloomfield State Bank, 2011 WL 1773953, at *3, *4.

So Is Judge Posner Correct?

In economic terms, the result in *Bloomfield State Bank* is surely correct. As Judge Posner points out, had the borrower's land been sold at a foreclosure sale, Bloomfield's prior-recorded mortgage would have given it clear priority over the IRS for the sale proceeds. In Posner's view, rents are economically indistinguishable from sale proceeds for priority purposes:

> Whether the proceeds from the enforcement of a lender's lien take the form of sale income or rental income is a detail of no significance. To say that a parcel of land is "sold" rather than "rented" just means that the owner sells the use of the land forever rather than for a limited period. Sale income and rental income are just two forms of proceeds from land (or from improvements on it).

Bloomfield State Bank, 2011 WL 1773953, at *3. This equivalence is well-established in Article 9, which defines "proceeds" to include "whatever is acquired upon the sale, lease, license, exchange, or other disposition of collateral." UCC § 9-102(a)(64)(A). As an economic matter, the same *should* be true under the law of real estate finance. See R. Wilson Freyermuth, *Of Hotel Revenues, Rents, and Formalism in the Bankruptcy Courts: Implications for Reforming Commercial Real Estate Finance*, 40 UCLA L. Rev. 1461, 1533 (1993) ("[a]n agreement to occupy a commercial real estate project fits squarely within the concept of 'proceeds' of the project").

In addition, Judge Posner appropriately distinguishes *Bloomfield State Bank* from prior cases according the IRS priority for accounts arising after the tax lien filing. Even though rents are technically "accounts" under Article 9, a lien on rents is not strictly analogous to a security interest in after-acquired accounts receivable. All rents are identifiable proceeds of the underlying land, but not all accounts are identifiable proceeds of other collateral; some are (for example, an account arising out of the debtor's sale of inventory collateral), and some are not (for example, an account arising out of the debtor's provision of personal services). Only when an account does not constitute proceeds of a secured party's pre-existing collateral should the IRS tax lien take priority over the secured party. The appropriate analogy here is to Bankruptcy Code § 552; although Bankruptcy Code § 552(a) renders ineffective a secured party's after-acquired property clause as of the petition date, Bankruptcy Code § 552(b) makes clear that a secured party's perfected security interest in pre-petition collateral also extends to rents and proceeds of that collateral that are received by the debtor post-petition. 11 U.S.C. § 552(b).

So . . . What's the Problem?

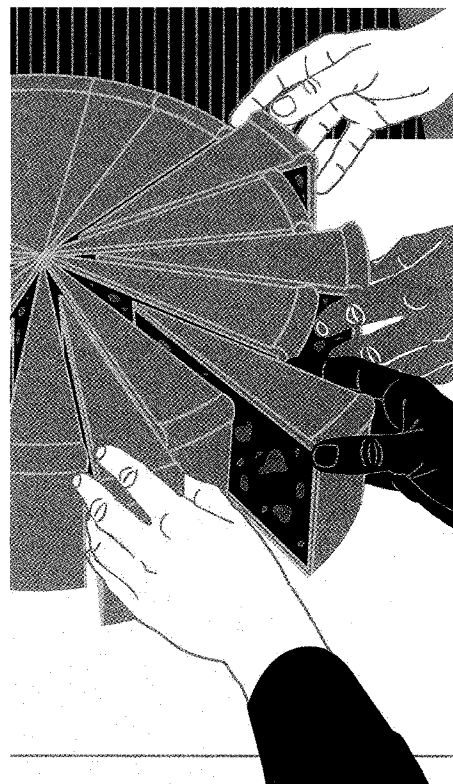
In terms of the ultimate result in the *Bloomfield State Bank* case, there is no problem. As noted above, the mortgagee's lien prevailed over the federal tax lien, as it should have. Nevertheless, in reaching this result, Judge Posner does make a rather interesting "restatement" of real estate finance law. In equating rents and proceeds, Judge Posner states:

> [The equivalence of rents and proceeds] would have been obvious in this case had not the mortgage contained a provision stating that the rental income generated by the borrower's real estate was additional collateral securing the mortgage. That makes it seem as if the rental income is a distinct form of property rather than merely proceeds of owning a rented property. Actually the rental-income provision in the mortgage is a superfluity.

Bloomfield State Bank, 2011 WL 1773953, at *3. Taking this statement at its face, it implies that a mortgage on land automatically extends to rents—even if there is no explicit assignment of rents in the mortgage—in the same sense that an Article 9 security interest in personal property automatically extends to proceeds of collateral. But, although automatic proceeds coverage is explicitly codified in Article 9, UCC §§ 9-203(f), 9-315(a)(2), modern real estate finance law has not typically recognized rents coverage as being implicit in a mortgage.

Under the historical "title theory" of mortgages, a mortgage was viewed as a transfer of legal title (and the legal right to possession) at the time of the mortgage's execution and delivery. Under this conception, of course, a mortgage would implicitly cover rents, because the right to lease the property and collect rents would flow as a natural incident of the mortgagee's legal title. The vast majority of American jurisdictions, however, has long since adopted the "lien theory" of mortgages, under which the mortgage merely creates a lien on the land, with the mortgagor retaining legal title unless that title is extinguished in a foreclosure sale. Under the lien theory, a mortgagee is not entitled to collect rents merely by virtue of its status as a mortgagee. Instead, the mortgagee in a lien theory state can only collect rents before foreclosure if it becomes a mortgagee-in-possession, obtains the appointment of a receiver, or has taken and properly enforces an assignment of rents. Grant S. Nelson & Dale A. Whitman, 1 *Real Estate Finance Law* § 4.20, at 270; § 4.23, at 279 (5th Pract. ed. 2007). Against this background, it is wrong to characterize an assignment of rents as a "superfluity."

I come to praise Judge Posner, not to bury him. I agree with him—under real estate finance law, a mortgage lien should automatically extend to rents. Article 9 has it right with its automatic proceeds coverage, and real estate



finance law should embrace that approach. Where adopted, the Uniform Assignment of Rents Act (UARA), 7 IA U.L.A. 1 (2006), would do so, because UARA § 4(a) provides that a mortgage automatically creates a lien on rents arising from the mortgaged property unless the mortgage provides otherwise. UARA § 4 cmt. 1 ("the Act adopts a default rule comparable to the 'proceeds' rules of Uniform Commercial Code Article 9"). It is hoped more states will join Nevada, Utah, New Mexico, and Texas in enacting the UARA or a comparable statute. In the meantime, however, mortgage lenders should keep taking those assignments of rents. ■