Maryland Law Review

Volume 24 | Issue 3 Article 3

The No Property Rule in Federal Tax Lien Litigation

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Comments and Casenotes

THE NO PROPERTY RULE IN FEDERAL TAX LIEN LITIGATION

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Since 1950[1] the United States Government has enjoyed great success in federal tax lien[2] priority contests in which the United States has asserted its lien against the property of the taxpayer either before or after another party had also asserted a lien.[3] These cases had diminished the measure of security afforded to lien-holders competing with the federal tax lien.[4] But in 1960 the Supreme Court, in *Aquilino v. United States*[5] and *United States v. Durham Lumber Co.*,[6] established what has come to be known as the "no property" rule.[7] The rule and the cases decided under it have matured into what amounts to an exception to the decisions in the priority cases. Before discussing the rule

[1] United States v. Security Trust & Sav. Bank, 340 U.S. 47 (1950). In this case the Supreme Court extended the choateness test, theretofore applied to the insolvent debtor statute, REV. STAT. § 3466 (1875), 31 U.S.C. § 191 (1958), to the tax lien statute as well.

[2] INT. REV. CODE of 1954, § 6321 provides:

> "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." (Emphasis added.)

[3] For some of the leading articles in the huge collection of material written on priority contests see: Anderson, *Federal Tax Liens — Their Nature and Priority*, 41 CALIF. L. REV. 241 (1953); Kennedy, *The Relative Priority of the Federal Government: The Pernicious Career of the Inchoate and General Lien*, 63 YALE L.J. 905 (1954); Plumb, *Federal Tax Collection and Lien Problems*, 13 TAX L. REV. 459 (1958); Wolfson, *Federal Tax Liens—A Study in Confusion and Confiscation*, 43 MARQ. L. REV. 180 (1959).

[4] United States v. Vorreiter, 355 U.S. 15 (1957), *rev'd per curiam*, 134 Colo. 543, 307 P. 2d 475 (1957); United States v. White Bear Brewing Co., 350 U.S. 1010 (1956), *rev'd per curiam*, 227 F. 2d 359 (7th Cir. 1955); United States v. Colotta, 350 U.S. 808 (1955), *rev'd per curiam*, 224 Miss. 33, 79 So. 2d 474 (1955); United States v. Scovil, 348 U.S. 218 (1955); United States v. Liverpool & London & Globe Ins. Co., 348 U.S. 215 (1955); United States v. Acri, 348 U.S. 211 (1955); United States v. City of New Britain, 347 U.S. 81 (1954); United States v. Gilbert Associates, Inc., 345 U.S. 361 (1953); United States v. Security Trust & Sav. Bank, 340 U.S. 47 (1950); Illinois *ex rel.* Gordon v. Campbell, 329 U.S. 362 (1946); United States v. Waddill, Holland & Flinn, Inc., 323 U.S. 353 (1945).

[5] 363 U.S. 509 (1960).

[6] 363 U.S. 522 (1960).

[7] For a case referring to it as the "no debt" theory, see Wolverine Ins. Co. v. Phillips, 165 F. Supp. 335 (N.D. Iowa 1958). It was called the "residue" rule by the same district three years later. Randall v. Colby, 190 F. Supp. 319 (N.D. Iowa 1961). For a law review article citing it as the "no property" theory see Note, 8 U.C.L.A.L. REV. 212 (1960-61).

and its ramifications, a brief look at the priority cases is in order to fully appreciate the importance of the no property rule.

I. THE PRIORITY CONTESTS

The federal tax lien[8] has no built-in priority. Congress left it to the courts to determine the factors to be considered when a federal lien conflicted with a lien of another party. In *United States v. Security Trust & Sav. Bank*,[9] the first priority case decided by the Supreme Court, the tax lien was asserted against a local attachment lien which arose prior to the time notice of the tax lien was filed but on which no judgment was obtained until after the tax lien was filed. The Court stated that when a state-created lien competes with a federal tax lien, federal law controls and state classification of a state-created lien becomes subject to re-examination by the Supreme Court under federal law. After establishing this principle, the Court adopted the choateness test and held that the attachment lien was inchoate at the time the tax lien arose, with the result that the federal tax lien took priority.

It was not until *United States v. City of New Britain*[10] that the Supreme Court specified the elements of the choateness test. There, the federal tax lien was competing with city liens for real estate taxes and water rents. Almost incidentally the Court specified the elements of a choate or perfected lien, which was said to exist "when the identity of the lienor, the property subject to the lien, and the amount of the lien are established."[11] The Court also introduced "the first in time, first in right" principle.[12] Applying these two rules, the Court found that certain of the city's liens became choate before the tax lien arose and were prior to the federal tax lien. The Court did not apply the choateness test to the federal tax lien, treating it as perfected as soon as the assessment lists were filed. It remanded the case to the state court to decide the priorities in the light of the principles established. Significantly, *New Britain* remains one of the few Supreme Court cases in which a

[8] For a good discussion of the mechanics of the lien see Mosner, *The Nature and Scope of Federal Tax Liens With A Special Consideration of Their Effect on Mortgage Foreclosures*, 17 MD. L. REV. 1 (1957).

[9] 340 U.S. 47 (1950).

[10] 347 U.S. 81 (1954).

[11] *Id.* at 84.

[12] *Id.* at 85.

competing lien was held choate and prior to a federal tax lien under the "first in time"[13] principle.

After *New Britain,* the Supreme Court consistently denied mechanic's liens[14] the standing they had previously been given in federal tax lien contests. In *United States v. Vorreiter,*[15] *United States v. White Bear Brewing Co.*[16] and *United States v. Colotta,*[17] the Supreme Court refused state court characterization of local liens,[18] creating the impression that a mechanic's lien which falls short of judgment could not become choate to defeat a tax lien. After these cases, it might have been concluded that to defeat the tax lien, a lienor would have had to qualify as a judgment creditor or under one of the other three exceptions of section 6323 (a) of the Internal Revenue Code of 1954.

The next two priority cases to reach the Supreme Court resulted in an extension of the choateness test to contractual liens. In *United States v. Ball Construction Co.,*[19] involving an assignment of accounts to become due, the assignee's lien was determined to be inchoate. In *Crest Finance Co. v. United States,*[20] the Solicitor General conceded the choateness of the assignee's lien. In its latest pronouncement in the priority area, *United States v. Pioneer American Insurance Co.,*[21] the Court attempted to rationalize the *Ball* and *Crest* cases on the factual differences between the assignment involved, pointing out that a lien base on an assignment to secure future indebtedness can-

[13] The Court handed down three priority opinions in 1955 in which the local lienholders could not satisfy the elements of choateness. United States v. Liverpool & London & Globe Ins. Co., 348 U.S. 215 (1955), involved a garnishment lien; United States v. Acri, 348 U.S. 211 (1955), an attachment lien; and United States v. Scovil, 348 U.S. 218 (1955), a distress lien for rent. Two recent decisions subordinating the tax lien are Crest Finance Co. v. United States, 368 U.S. 347 (1961); and U.S. v. Vermont, 377 U.S. 351 (1964). See also U.S. v. Pioneer Ins. Co., 374 U.S. 84 (1963).

[14] See Note, 68 YALE L.J. 138 (1958), for a comprehensive discussion of the mechanic's lien laws of the various states.

[15] 355 U.S. 15, *rev'd per curiam,* 134 Colo. 543, 307 P. 2d 475 (1957).

[16] 350 U.S. 1010 (1956), *rev'd per curiam,* 227 F. 2d 359 (7th Cir. 1955).

[17] 350 U.S. 808, *rev'd per curiam,* 224 Miss. 33, 79 So. 2d 474 (1955).

[18] Plumb, *Federal Tax Collection and Lien Problems,* 13 TAX L. REV. 459, 505 (1958), points to a contemporaneous state court opinion as best representing the reasoning of the Supreme Court at this time. Fleming v. Brownfield, 47 Wash. 2d 857, 290 P. 2d 993 (1955), where the Supreme Court of Washington found a mechanic's lien failed to reach federal standards.

[19] 355 U.S. 587 (1958), *rev'd per curiam,* 239 F. 2d 384 (5th Cir. 1956), *aff'd mem., sub nom.,* R. F. Ball Constr. Co. v. Jacobs, 140 F. Supp. 60 (W.D. Tex. 1956). For a recent discussion of this case and its aftermath see Note, *Federal Priorities and Tax Liens,* 63 COLUM. L. REV. 1259, 1280-81 (1963).

[20] 368 U.S. 347 (1961), *vacated per curiam,* 291 F. 2d 1 (7th Cir. 1961). Note, 63 COLUM. L. REV. 1259, 1281, *supra* note 19.

[21] 374 U.S. 84 (1963). See also United States v. Buffalo Sav. Bank, 371 U.S. 228 (1963), where the federal tax lien was given priority over a lien for local taxes in a foreclosure sale.

not be choate and prior to a federal tax lien, but that an assignment consummated prior to the accrual and filing of the federal lien can satisfy the choateness test.[22]

Although some doubt remains as to the applicability of the priority rules to particular facts, it can be said that a competing lien is prior to a federal tax lien if it meets the choateness and "first in time" tests. An alternative way of defeating the federal tax lien is through the no property rule, to which we now turn.

II. The No Property Rule

The no property rule is best understood by assuming a hypothetical but typical situation in the construction industry, where its application most often arises. The taxpayer is a general contractor who has completed the work for the owner but has failed to pay all of his subcontractors. He is also indebted to the United States for unpaid taxes. The owner has not paid the full contract price, but has retained a percentage[23] of that amount. The subcontractors ask the owner to pay them, usually filing or threatening to file their mechanic's liens against the owner's property. The Government asserts its tax lien on all the "property and rights to property"[24] of the contractor. At this point the main distinction from a priority case becomes apparent. Two competing liens have been asserted against two different parties. In the priority cases, liens are asserted against the property of only one party because he is both the taxpayer and the person holding property which the other lienholders are after. In a no property case, the Government seeks to enforce its lien, normally by notice of levy, against property held by one other than the taxpayer.

This situation gives rise to the vital question which underlies a no property case, whether it be in the construction field or in others: Is there any debt owing to the taxpayer to which the Government's lien can attach? If there is no such debt, the Government has no lien, and it is immaterial whether or not the subcontractor has a choate lien at the time the Government asserts the tax lien.

In the construction area, the no property situation exists when the taxpayer-contractor has lost his contractual right

[22] *Id.* at 91.

[23] On state jobs the state might have a statutory requirement that fifteen percent be retained. N.Y. State Fin. Law § 139 (Supp. 1958). See 5 Md. Code art. 63, § 13 (1957). In Maryland the owner isn't authorized to retain anything from the contract price until he receives notice of a claim from a subcontractor. But on private jobs in Maryland the practice is for the owner to retain a percentage of the contract price, usually fifteen percent.

[24] See Int. Rev. Code of 1954, § 6321.

to claim the unpaid balance which the owner holds and which the Government seeks to collect.

The first significant exposition of the no property rule appeared in a Second Circuit decision, *Fidelity & Deposit Co. v. New York City Housing Auth.*[25] The contractor had completed the installation of heating and ventillating facilities but failed to pay his laborers and materialmen. The Government filed a tax lien on the property of the contractor-taxpayer. Under his contract, the contractor was required to supply a payment and performance bond to the owner, the Housing Authority. Fidelity, who was surety on this bond, paid the laborers and materialmen what the contractor owed on the job and claimed the entire unpaid balance held by the owner. The district court[26] held in favor of the United States. The Court of Appeals reversed and found that the contractor had no property rights under the contract with the owner in the retained balance to which the tax lien could attach. The court, looking to New York contract law,[27] construed the contractor's failure to pay his materialmen and laborers as a breach of the contract depriving the contractor of his property rights in the contract balance. Since the Government's lien failed to attach, the Circuit Court remanded the case to the district court to reconsider the surety's claim.

The Second Circuit's opinion rested mainly on New York contract law, but it launched into a discussion of the relationship between state law and the federal tax lien. At the center of this discussion was the Supreme Court's opinion in *Morgan v. Commissioner*,[28] in which the Court

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[25] 241 F. 2d 142 (2d Cir. 1957). See Note, 66 YALE L.J. 797, 801 (1957), for a critical opinion of the case by a writer more concerned with the uniform administration of the tax laws than with the development of the no property rule. The "uniformity" argument is often met in the tax collection area. The dissenting opinion in Commissioner v. Stern, 357 U.S. 39 (1958), is a clear statement of it. For some development leading up to the *New York Housing* decision see Karno-Smith Co. v. Maloney, 112 F. 2d 690 (3d Cir. 1940); United States v. Western Union Telegraph Co., 50 F. 2d 102 (2d Cir. 1931); United States F. & G. Co. v. Triborough Bridge Authority, 297 N.Y. 31, 74 N.E. 2d 226 (1947).

[26] 140 F. Supp. 298 (S.D. N.Y. 1956). The court held that the contractor had a conditional right to the fund which qualified as a "right to property" under Int. Rev. Code of 1939, § 3670 now INT. REV. CODE of 1954, § 6321.

[27] United States F. & G. Co. v. Triborough Bridge Authority, 297 N.Y. 31, 74 N.E. 2d 226 (1947), was a no property case where the New York Court of Appeals declared that a failure by a contractor to pay his mechanics was as much a default of the contract with the owner as was not completing the work.

[28] 309 U.S. 78 (1940). In this case the question appeared to be whether a power of appointment granted to the deceased taxpayer was general or special under Wisconsin law for the purpose of taxing it to the taxpayer's estate under the federal revenue act. The Supreme Court stated that it was

expounded the well-recognized principle that "[S]tate law creates legal interests and rights."[29] However, the Court went on to say, "If it is found in a given case that an interest or right created by local law was the object intended to be taxed, the federal law must prevail no matter what name is given to the interest or right by state law."[30] The circuit court pointed out that the Supreme Court had recognized this distinction in the lien priority cases but that there had been no doubt in those cases that the taxpayer had some interest in the disputed property to which the tax lien could attach and that the question involved had been solely one of priorities.[31]

In 1958 the Supreme Court heard its first no property case in *United States v. Bess*.[32] This was a case where the property in question was the proceeds of the taxpayer's life insurance policy. The Court cited *New York Housing*[33] for the proposition that state law creates property rights, but the Court went on to add that the federal lien statute "creates no property rights but merely attaches consequences, federally defined, to rights created under state law."[34] It held that the tax lien could not attach to the pro-

unnecessary to resolve the issue of how the state law would characterize the power, holding that the power was general within the intent of the revenue act.

[29] *Id.* at 80.

[30] *Id.* at 81. As will be evident later, this distinction is the basis for victory by the Government in the lien priority area and defeat in the no property cases.

[31] Fidelity & Deposit Co. v. New York Housing Auth., 241 F. 2d 142, 145 (2d Cir. 1957). The court denied the argument that substantial performance by the contractor gave him the right to sue for the retained fund. The Government also argued that the contract only required that the materialmen "somehow" be paid, not necessarily by the contractor. The court held there was a condition precedent that the contractor be the one to pay them.

[32] 357 U.S. 51 (1958). The Government asserted its lien against a policy taken out by the deceased taxpayer on which he had paid all the premiums. The Government sought to collect the proceeds of the policy paid to the beneficiary, but the Court limited it to the cash surrender value of the policy. It held the taxpayer had no property interest in the proceeds of the policy under state law during his lifetime so the federal lien couldn't attach. But he did have the right to borrow against the cash surrender value of the policy. The Court found this to be a chose in action which qualified as "property" or "rights to property" within the statute. While looking to state law to construe the taxpayer's interest under the policy, the Court disregarded the fact that under state law the beneficiary of a policy was free of the claims of creditors of the insured except to the extent of the amount of any premiums paid in fraud of creditors. In a companion case, Commissioner v. Stern, 357 U.S. 39 (1958), the Court treated the Government the same as an ordinary creditor of the insured under state law and barred the tax lien from attaching. The different decisions are rightly justified by the fact that a state law in *Bess* made the insured's right to borrow on the cash surrender value a property interest, while no such law existed in *Stern*.

[33] *Id.* at 55.

[34] *Ibid.*

ceeds of the policy since, under state law, the taxpayer-insured had no property interest in the proceeds. But, said the Court, the lien could attach to the cash surrender value since the taxpayer could have borrowed up to its full value in his lifetime. Considering the Government's unusual persuasiveness in the priority cases, *Bess* foreshadowed the result in *Aquilino v. United States*[35] and *United States v. Durham Lumber Co.*[36] in 1960.

In *Aquilino* the contractor agreed to remodel a restaurant. He hired various subcontractors who performed their contracts but were not paid. They filed mechanic's liens against the balance of the main contract which had been retained by the owner. The United States had filed its assessment lists against the contractor, thereby perfecting its lien, even before he had entered into the main contract. This appeared to create the strongest possible priority case for the Government. Not only could it claim "first in time is first in right" but it could also stand on the expected inchoateness of the competing state liens under the priority cases. Before the New York Court of Appeals,[37] the subcontractors tried to distinguish their case from the lien priority cases by pointing out that the tax lien was not being asserted against any real property owned by or possibly owned by the taxpayer. They also asserted that under the state lien law[38] the contractor had no property interest in the fund and that under the trust fund provisions of the state's lien law the court would be justified in not applying the choateness test. If this argument were accepted, the taxpayer would have "no property" in the contract balance to which the tax lien could attach with the result that reliance on the "first in time" rule would also be unjustified. The New York Court of Appeals treated the case as a priority contest nonetheless and refused to construe the trust fund provisions in a manner to "defeat the paramount right of the United States to levy and collect taxes uni-

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[35] 363 U.S. 509 (1960).

[36] 363 U.S. 522 (1960).

[37] Aquilino v. United States, 3 N.Y. 2d 511, 146 N.E. 2d 774, 169 N.Y.S. 2d 9 (1957).

[38] N.Y. Sess. Laws 1930, ch. 859, § 18. The section provided in part: "The funds received by a contractor from an owner for the improvement of real property are hereby declared to constitute trust funds in the hands of such contractor to be applied first to the payment of claims of subcontractors, architects, engineers, surveyors, laborers and materialmen arising out of the improvement." The section also provided that any person entitled to share in the fund may enforce the trust by civil action. Diversion of such funds by the general contractor is declared to constitute larceny.

formly throughout the land."[39] It held the federal lien had priority.

When *Aquilino*[40] was argued before the Supreme Court, the subcontractors were successful in distinguishing their case from the prior mechanic's lien contests the Court had considered. The Court began its opinion by stating:

> "The threshold question in this case, as in all cases where the Federal Government asserts its tax lien, is whether and to what extent the taxpayer had 'property' or 'rights to property' to which the tax lien could attach."[41]

This was the first of a three-step process the Court was to go through in order to establish the no property rule. This first step was a statement of the prerequisite for the tax lien to attach. The Court next cited *Morgan v. Commissioner*[42] for the proposition that property interests are created under state law, a proposition which fitted neatly into the terms of tax lien statute.[43] Finally, it cited *United States v. Bess*,[44] which reiterated that the tax lien statute itself did not create any property interests. The Court concluded that the priority question need not be reached at all. After the Court completed its no property thesis, it recognized the priority decisions which it had already implicitly distinguished. The Court proceeded to remand the case to the state court to resolve the question of the nature of the property right of the taxpayer.[45]

In *Durham*,[46] the contractor had agreed to construct several buildings for the owner. He hired various sub-

[39] Aquilino v. United States, 3 N.Y. 2d 511, 146 N.E. 2d 774, 777, 169 N.Y.S. 2d 9 (1957). One writer has implied that had the Supreme Court's decision in United States v. Bess, 357 U.S. 51 (1958), been handed down at the time of *Aquilino* the New York Court of Appeals might have decided the case differently. Note, 36 N.Y.U.L. REV. 1316, 1324 (1961).

[40] 363 U.S. 509 (1960).

[41] *Id.* at 512.

[42] 309 U.S. 78 (1940).

[43] This definition of property rights under state law was not so well entrenched that the Government did not advocate a federal definition of property. It suggested that future decisions would supply content to such a body of law. The Court rejected the argument, standing on its decisions in *Morgan* and *Bess* rather than usurp the role of the states which were already incensed over the priority cases. The latter had refused recognition to state characterization of property interests.

[44] 357 U.S. 51 (1958). See Note, *Property Subject to the Federal Tax Lien*, 77 HARV. L. REV. 1485 (1964).

[45] In Aquilino v. United States, 10 N.Y. 2d 271, 176 N.E. 2d 826, 219 N.Y.S. 2d 254 (1961), the New York Court of Appeals held on remand that the taxpayer did not have sufficient equitable interest in the fund in the owner's hands to give him a property right. It characterized the subcontractors as the beneficiaries of a true trust rather than mere lienors.

[46] United States v. Durham Lumber Co., 257 F. 2d 570 (4th Cir. 1958).

contractors who completed their jobs but were not paid. They filed notices of their claims with the owner, but before the subcontractor filed their notices the tax lien was filed against the contractor. Two of the subcontractors brought suit to reach the unpaid balance on the main contract. They did not attempt to attain choateness by claiming an ordinary mechanic's lien. However, they were able to persuade the Fourth Circuit to put aside the priority cases and recognize that it was confronted with a different situation, one calling for an examination of the nature of the right of the subcontractor, as asserted in North Carolina, against the owner of the improved property.[47] The Fourth Circuit Court of Appeals examined the North Carolina statutes and concluded that a subcontractor who notifies an owner of his claim has a lien upon the improved real estate and an independent cause of action against the owner in his own right. The court also noted that the owner cannot avoid or reduce his direct liability by payment or settlement with the general contractor.[48] Because of this independent right of action in a subcontractor who has filed notice, the court held that the contractor was left without property to which the tax lien might attach. Further it distinguished the case before it from the priority cases on the facts as well as on the lien statute involved. It refused to extend the priority of a tax lien asserted against the taxpayer's property to the property of the taxpayer's debtor. The court cited the *New York Housing* case[49] as authority for its no property holding and chided the New York Court of Appeals for not being aware of the decision of the Second Circuit. Finally the court adopted the holding in *United States v. Bess*[50] to bolster its conclusion.

In deciding *Durham*,[51] the Supreme Court merely affirmed the strong opinion of the Fourth Circuit as to the effect of the North Carolina statutes on the subcontractor's claim and agreed that the lien statute created a no property situation which warranted avoidance of any priority claim.

Subsequent to these two decisions, other courts have looked favorably on the no property doctrine. This was to be expected in the light of the unpopularity of the priority decisions.

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[47] *Id.* at 572.

[48] *Id.* at 573, N.C. GEN. STAT. §§ 44-46, 44-48, 44-49 (1950).

[49] 241 F. 2d 142 (2d Cir. 1957).

[50] 357 U.S. 51 (1958). The circuit court also stated that had the New York Court of Appeals had the benefit of *Bess*, it would have adopted a contrary stand in *Aquilino*.

[51] 363 U.S. 522 (1960).

In discussing these recent cases it is necessary to distinguish between the contractual interpretation cases[52] and those involving application of lien statutes.[53] Three of the latter have involved the mechanic's lien statutes of Indiana, Iowa[54] and Washington,[55] each holding that the lienholder had a direct and independent claim against the contract balance retained by the owner.

In *United States v. Chapman*,[56] the Tenth Circuit, citing both *Aquilino* and *Durham*, found it could not rely on the Oklahoma lien statute because it contained no provision similar to that of New York or North Carolina. However, the court concluded that the absence of such statute did not preclude application of the no property rule because the contract involved contained a condition precedent to payment of the balance, whereas the obligations to the taxpayers in *Aquilino* and *Durham* appeared to be absolute. As an alternative basis for its decision, the court looked to Oklahoma contract law to construe the condition in the contract for payment of the mechanic's claims and held against the Government on the ground that, under the contract, the owner was not obligated to pay the balance to the taxpayer. By the same token, in *Fidelity and Casualty Company of New York v. Dykstra*,[57] a subrogating surety competing with the Government used the contract argument to its fullest extent by persuading the federal district court to rely on Minnesota contract law and the *New York Housing*[58] and *United States F. & G. Co. v. Triborough Bridge Authority*[59] cases as its basis for the decision that the tax lien would not attach.

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[52] Examples already looked at prior to *Aquilino* and *Durham* are Fidelity & Deposit Co. v. New York Housing Auth., 241 F. 2d 142 (2d Cir. 1957); United States F. & G. Co. v. Triborough Bridge Authority, 297 N.Y. 31, 74 N.E. 2d 226 (1947).

[53] N.Y. Sess. Laws 1930, ch. 859, § 18; N.C. GEN. STAT. §§ 44-6, 44-8, 44-9 (1950).

[54] Community School District of Eldora v. Employers Mutual Casualty Co. of Des Moines, 194 F. Supp. 733 (N.D. Iowa 1961). The Iowa lien statute is contained in IOWA CODE, ch. 573 (1958). It requires that all public corporations retain at least ten percent of the contract price for the benefit of unpaid laborers and materialmen.

[55] Johnson Service Company v. Roush, 57 Wash. 2d 80, 355 P. 2d 815 (1960).

[56] 281 F. 2d 862 (10th Cir. 1960). For two other recent no property decisions see Capital Fire & Casualty Co. v. City of Birmingham, Ala., 10 Am. Fed. Tax R. 2d 5967 (1962); Randall v. Colby, 190 F. Supp. 319 (N.D. Iowa 1961).

[57] 208 F. Supp. 717, 722 (D. Minn. 1962).

[58] 241 F. 2d 142 (2d Cir. 1957).

[59] 297 N.Y. 31, 74 N.E. 2d 226 (1947).

III. OTHER APPLICATIONS OF THE RULE

In *Aquilino* and *Durham* the Supreme Court established the no property rule in the construction area where it is normally a mechanic's lienholder who is competing with the federal tax lien. Prior to these cases it had been decided that the no property rule could be applied where the proceeds of an insurance policy[60] were contested, rather than the balance of a construction contract. With these cases as authority for the rule that state law must be looked to as the source of property rights, the courts have broadened the application of the no property rule.

In *Karno-Smith Co. v. Maloney*[61] the taxpayer, a subcontractor, failed to pay his supplier. Following the subcontractor's default the contractor paid the subcontractor's debt to the supplier, as was required in the contractor's bond with the owner. When the United States asserted its tax lien against the balance of the subcontract held by the contractor, the court allowed the contractor to set-off against this fund to the extent he had covered the debt of the subcontractor. This resulted in no property being left in the subcontractor to which the federal lien could attach.

In *United States v. Winnett*[62] a debtor contracted to make good on the notes of his creditor given to a bank. The contract provided for set-off by the debtor against his debt to the creditor should he have to cover the latter's notes. A federal tax lien was filed against the creditor. Subsequently he defaulted on his notes and the debtor paid the bank what was due. When the Government tried to collect from the debtor the amount of his original debt to the creditor, the Ninth Circuit looked to state law to determine the property interests of the taxpayer-creditor and the effect of the set-off contract and held the set-off related back to the date of the set-off agreement, which preceded the tax lien. The result was that the property was no longer that of the taxpayer and the lien failed to attach.[63]

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[60] United States v. Bess, 357 U.S. 51 (1958); Commissioner v. Stern, 357 U.S. 39 (1958); See Riesenfeld, *Life Insurance and Creditors' Remedies in the United States*, 4 U.C.L.A.L. REV. 583 (1956-57).

[61] 112 F. 2d 690 (3d Cir. 1940).

[62] 165 F. 2d 149 (9th Cir. 1947).

[63] *Cf.* United States v. Bank of the United States, 5 F. Supp. 942 (S.D. N.Y. 1934), where a situation comparable to a set-off arose. The Government tried to satisfy its lien from the balance of the taxpayer's checking account. Before the lien arose the taxpayer had become liable to the bank on a demand note. In the contest between the Government and the bank the court found no property in the taxpayer. The depositor was said to

The no property rule has also been applied in the bankruptcy field. In the only case in Maryland approaching the no property point, the Maryland Court of Appeals denied arguments of a trustee in bankruptcy who was trying to assume the position of the United States as lienholder under section 70(e) of the Bankruptcy Act in order to set aside an unrecorded chattel mortgage and its foreclosure. In *Wethered v. Alban Tractor Co.*[64] the bankrupt had given a chattel mortgage on construction machinery. The trustee in bankruptcy was seeking to recover the proceeds from the subsequent chattel mortgage foreclosure sale. The chattel had been sold for cash in full and delivered to a bona fide purchaser twenty-six days before the first notice of the federal tax lien was filed against the bankrupt. The court held that under Maryland law payment and delivery are all that is needed to vest legal title in the bona fide purchaser, with the result that there was no property left in the bankrupt for the lien to attach and the trustee could not assume the position of such a lienholder under section 70(e).[65]

In a Second Circuit decision[66] an assignment for the benefit of creditors under New York law was upheld against the Governor's claim of priority for a tax lien under section 67 (b) of the Bankruptcy Act. Since the assignment had been perfected under state law prior to the filing of the petition in bankruptcy, a no property situation existed when the Government filed its lien against the bankrupt.

An application of the no property rule in the field of trusts arose in a case involving the unique features of the "Illinois land trust",[67] which vests both legal and equitable title in the trustee. After the taxpayer placed the real estate in question under the trust, the tax lien was filed. In a state where this type of trust has found great favor,

have only a revocable license to make deposits and withdrawals, and when the bank asserted its interest under the demand note the taxpayer was left with nothing to which the lien could attach. See also Beeghly v. Wilson, 152 F. Supp. 726 (N.D. Iowa 1957), where the set-off arose under a contract provision but the tax lien was granted priority.

[64] 224 Md. 408, 168 A. 2d 363 (1961). For other aspects of this case see O'Toole Tire Co. v. Gaither, Inc., 216 Md. 54, 139 A. 2d 252 (1958); Plaza Corp. v. Alban, 219 Md. 570, 151 A. 2d 170 (1958).

[65] The court also turned down an argument of the trustee under § 70(c) of the Bankruptcy Act, 30 Stat. 556 (1898), 11 U.S.C. § 110(c) (1953), since the bankruptcy petition had not been filed until sixteen months after the chattels were sold.

[66] City of New York v. United States, 283 F. 2d 829 (2d Cir. 1960). In upholding the New York law and the no property rule the court concluded that the Bankruptcy Act had not superseded the effect of the New York property law.

[67] Chicago Federal Savings & Loan Ass'n v. Cacciatore, 33 Ill. App. 2d 888, 178 N.E. 2d 888 (1961).

the Government tried to avoid the effect of Illinois law sanctioning this trust. The Illinois Court, however, employed the rule laid down in *Aquilino* and *Durham* and held the trust property to be immune from the lien.

IV. THE NO PROPERTY RULE IN THE CONSTRUCTION AREA

The variety of situations in which the rule has been applied indicates the breadth of its application. It remains for the courts to indicate how far the rule may be extended. However, in the construction area the way is clear to use the no property rule as now developed.

Essential to an effective application of the rule is a recognition of the two ways a no property situation arises in this area, namely, contract stipulation and state lien law. The Supreme Court's decisions in *Aquilino* and *Durham* point the way for state legislatures to enact statutes similar to the New York and North Carolina statutes.[68] Along these lines, it is noteworthy that Maryland's mechanic's lien statute allows a subcontractor to assert a lien for the full value of his claim without regard to the amount due the general contractor.[69] However, this liberal construction of the statute has not been extended to allow the enforcement of a mechanic's claim by direct action against the owner, as in *Durham*. One writer has expressed the opinion that the Maryland statute will never be construed to be of the type the Supreme Court dealt with in either *Aquilino* or *Durham*.[70] In view of the equitable considerations favoring an unpaid mechanic and the influence of the no property cases, the Maryland statute[71] arguably could be read to be of the *Durham* type.

To further the policy of the mechanics lien statutes, each state could amend its statute to come within the *Durham* decision. The doctrine of *Fidelity & Deposit Co. v. New York Housing Authority*[72] offers an alternative solu-

[68] The advisability of such a move by the states in any significant number is disapproved of on the ground that Congress would not stand by watching its tax revenue vanish. Baldinger, *Recent Supreme Court Decisions Affecting Federal Tax Liens*, 27 J.B.A.D.C. 351, 354 (1960). The practicality of states trying to alter their present lien laws to take advantage of the Supreme Court's rulings is doubted also. Shanks, *The Tax Lien Tamed*, 8 U.C.L.A.L. REV. 339 (1960-61).

[69] MD. ANN. CODE art 63, § 1 (1957), as amended, chs. 646 and 734, Acts 1959.

[70] Baldinger, *supra* note 68, at 355.

[71] MD. ANN. CODE art. 63, § 13 (1957).

[72] 241 F. 2d 142 (2d Cir. 1957). See Note, *Competing Mechanics and Federal Tax Liens: Conflicts Triggered By a General Contractor's Default*, 68 YALE L.J. 985, 999 (1959), for an excellent discussion of this suggestion

tion. In that case, the court interpreted the failure to pay materialmen or subcontractors as a default by the contractor under the primary contract. Some courts[73] have gone so far as to infer such a condition in a construction contract where subcontractors remain unpaid. Rather than relying on the possible implied terms, the owner can insert in the construction contract a condition precedent clause which clearly states that failure of the contractor to pay his laborers, materialmen and subcontractors shall be a breach of the main contract.[74] With such a clause in the contract, the Government's tax lien would be inferior to the owner's right to pay the retained funds to discharge any mechanic's lien.[75]

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where the author criticizes the Fourth Circuit for deciding *Durham* on the peculiar lien provisions instead of taking the approach of *New York Housing*, which was also open to it under the construction contract.

[73] Capital Fire & Casualty Co. v. City of Birmingham, 10 Am. Fed. Tax R. 2d 5967 (1962); F. H. McGraw & Co. v. Sherman Plastering Co., 60 F. Supp. 504, 512 (D. Conn. 1943).

[74] The American Institute of Architects is the leading authority which promulgates standard contract forms in the construction industry. PARKER & ADAMS, THE AIA STANDARD CONTRACT FORMS AND THE LAW (1954). See Art. 9, at p. 30 and Art. 32, at p. 50, for the language used in the standard contract relevant to the right of mechanics to be paid as against a federal tax lien.

[75] Although the owner is protected, unless a mechanic's lien is perfected or the contract or state law requires the owner to pay the materialmen and subcontractors from the retained funds, the tax lien may still prevail. Compare two recent cases, Fine Fashions, Inc. v. United States, 328 F. 2d 419, 421-22 (2d Cir. 1964); Youngstown S. & T. Co. v. Patterson-Emerson-Comstock of Ind., 227 F. Supp. 208 (N.D. Ind. 1963).