# THE CHOATE LIEN DOCTRINE*

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A TAXPAYER'S creditors may simultaneously include the federal government, state and local governments, and secured as well as unsecured commercial creditors. When there are insufficient funds to satisfy the maturing claims of all creditors, the age-old problem of priority arises. Ordinarily the lien first in time is first in right. This rule is based on the common-law equitable principle that "a prior lien gives a prior claim, which is entitled to prior satisfaction, out of the subject it binds . . . ."[1]

The right of the United States to priority does not arise from the common law, but depends entirely on statutes. The two principal statutory provisions are: section 3466 of the Revised Statutes;[2] and section 6321 of the 1954 Internal Revenue Code. In recent years there has been considerable confusion among members of the bar in the application of these two statutes. The reason for this confusion emanates from opinions of the United States Supreme Court holding that competing statutory and contractual liens must be choate before they can compete against the claims of the United States arising under these two statutes. Early cases used the term "specific and perfected" but in recent years the courts have often referred to a "specific and perfected" lien as a choate lien. The two terms are synonymous.

## I

### SECTION 3466, REVISED STATUTES

The characterization of liens as choate or inchoate for priority purposes initially developed from judicial interpretation of cases arising under section 3466 of the Revised Statutes. This section provides:

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* The views expressed are the author's and should not be considered as being the opinion of the Treasury Department, the Internal Revenue Service, or the Chief Counsel's Office.

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[1] Rankin v. Scott, 25 U.S. (12 Wheat.) 177, 179 (1827).

[2] REV. STAT. § 3466 (1875), 31 U.S.C. § 191 (1958).

Whenever any person indebted to the United States is insolvent, or whenever the estate of any deceased debtor, in the hands of the executors or administrators, is insufficient to pay all the debts due from the deceased, the debts due to the United States shall be first satisfied. . . .

Mere inability of a living debtor to pay all his debts does not constitute insolvency within the meaning of this section. A living debtor's inability to pay must be manifested or accompanied by one of the three ways pointed out in the explanatory clause of the section.[3] It must appear (a) that the insolvent debtor has made a voluntary assignment; or (b) the effects of an absconding, concealed, or absent debtor have been attached; or (c) that an act of bankruptcy has been committed.[4] Although it provides that the priority shall extend to cases where an act of bankruptcy is committed, the weight of authority indicates that this section is not applicable when bankruptcy results.[5] The Bankruptcy Act sets up its own priorities.

Section 3466 is a priority statute which arises at the time of the definitive act of insolvency.[6] It does not create a lien.[7] Taxes are debts within the meaning of the section and are subject to its protection.[8] While it is not a lien statute, the rules expressed and uniformly adhered to by the Supreme Court in its decisions under the section are reflected in the tax lien decisions. The Supreme Court has consistently held that inchoate liens, that is to say, liens which are not specific and perfected, do not prevail over debts due the United States in priority contests.

This section incorporates the priority first given the United States in 1797,[9] and has been described as broad and sweeping and, on its face, admits of no exception to the priority claims of the United States.[10] Nevertheless, the Supreme Court has recognized

[3] Conard v. Atlantic Ins. Co., 26 U.S. (1 Pet.) 386, 439 (1828); Nolte v. Hudson Nav. Co., 8 F.2d 859 (2d Cir. 1925).

[4] Bramwell v. United States Fid. & Guar. Co., 269 U.S. 483 (1926); United States v. Oklahoma, 261 U.S. 253 (1923); Nolte v. Hudson Nav. Co., 8 F.2d 859 (2d Cir. 1925).

[5] Guarantee Title & Trust Co. v. Title Guar. & Sur. Co., 224 U.S. 152 (1912); United States v. Gargill, 218 F.2d 556 (1st Cir. 1955); United States v. Sampsell, 153 F.2d 731 (9th Cir. 1946).

[6] County of Spokane v. United States, 279 U.S. 80, 93 (1929).

[7] Bramwell v. United States Fid. & Guar. Co., 269 U.S. 483, 488 (1926).

[8] Price v. United States, 269 U.S. 492 (1926).

[9] Derived from Act of March 3, 1797, ch. 20, § 5, 1 Stat. 515; and Act of March 2, 1799, ch. 22, § 65, 1 Stat. 676.

[10] United States v. Waddill, Holland & Flinn, Inc., 323 U.S. 353, 355 (1945).

that certain exceptions may be read into the statute. In *Thelusson v. Smith*,[11] one of the old and still often quoted cases, a judgment was held to be in an inferior position because the judgment creditor had not seized the property under *fieri facias*. The Court stated that a divestiture prior to insolvency would defeat the priority, since the United States must be satisfied out of the debtor's estate. This reasoning seems to form the basis from which the Court developed its requirement that the debtor must be divested of title or possession in order for the competing lien to be perfected.

It was contended in *Conard v. Atlantic Insurance Co.*[12] that the *Thelusson* case meant that the priority granted by section 3466 was superior to any lien and that only an absolute conveyance could defeat the priority. The Court answered by saying that "it has never yet been decided by this court, that the priority of the United States will divest a specific lien, attached to a thing, whether it be accompanied by possession or not."[13] The explanation of the Court implied that a specific and perfected lien would prevail over a mere priority of the United States, but in neither the *Thelusson* nor the *Conard* case did the Supreme Court answer the question. Although 145 years have elapsed since the *Thelusson* decision, and numerous cases have brought up the problem, the Supreme Court has been able to reserve its opinion on the question[14] by assiduously finding that the liens competing with the federal priority were not sufficiently specific and perfected.

While the Court has thus far declined to determine whether a specific and perfected lien would overcome the statutory priority, it has not been so reticent in setting forth requirements for a specific and perfected lien. The lien to be specific must be definite in at least three respects at the time of the act of insolvency, and not merely ascertainable in the future. These are: (1) the identity of the lienor, (2) the amount of the lien, and (3) the property to which it attaches.[15] "It is not enough that the lienor has power to bring these elements, or any of them, down from broad generality to the

[11] 15 U.S. (2 Wheat.) 396 (1817).
[12] 26 U.S. (1 Pet.) 386 (1828).
[13] *Id.* at 441.
[14] United States v. Gilbert Associates, 345 U.S. 361, 365 (1953); Illinois *ex rel.* Gordon v. Campbell, 329 U.S. 362, 370-71 (1946).
[15] United States v. Waddill, Holland & Flinn, Inc., 323 U.S. 353 (1945); United States v. Texas, 314 U.S. 480 (1941); United States v. Knott, 298 U.S. 544 (1936).

earth of specific identity."[16] To be perfected, the lien must be enforced at least to the point of divesting the debtor of either title or possession.[17]

In *County of Spokane v. United States*,[18] the Court held that liens for county corporation taxes which were assessed against the debtor's personalty before he went into receivership and before the section 3466 claim attached were not specific and thus were subordinate to the federal priority. The Supreme Court reasoned that the liens of the county were not "specific" as to property because they had not followed the necessary statutory procedure that consisted of distraining the property subject to their liens. Apparently, the Court believed that until actual distraint the counties had no way of knowing what property would be available to pay the taxes; hence, the liens could not meet the requirement of applying to specific and definite property.

The Supreme Court of Washington had held the liens of the two counties were not specific.[19] The United States Supreme Court said whether or not the liens were specific was a state question and accepted the ruling of the Washington court. The Court has not followed this language in subsequent decisions,[20] however, for later decisions have held that while it is a state question, it is subject to reexamination by the federal courts. Except for one case,[21] the Supreme Court has held all liens decided as choate by state courts to be inchoate under federal law.

A lien of the State of New York for franchise taxes under state law was held to be inferior to a debt due the United States.[22] The lien was held not to be specific and perfected, because the liability was unliquidated and unknown. Although the franchise taxes in question were overdue, the state had taken no steps to perfect and

[16] Illinois *ex rel.* Gordon v. Campbell, 329 U.S. 362, 375 (1946).

[17] United States v. Gilbert Associates, 345 U.S. 361, 366 (1953); New York v. Maclay, 288 U.S. 290 (1933).

[18] 279 U.S. 80 (1929). The state statutes involved provided that if a certain personal property tax was not paid, and if the personal property against which it had been assessed was no longer in the hands of the delinquent taxpayer, the amount of the unpaid tax would become a lien upon all the real and personal property of the taxpayer. They went on to prescribe the procedure by which the lien was to be enforced.

[19] Exchange Nat'l Bank v. United States, 147 Wash. 176, 265 Pac. 722 (1928).

[20] Illinois *ex rel.* Gordon v. Campbell, 329 U.S. 362 (1946); United States v. Waddill, Holland & Flinn, Inc., 323 U.S. 353 (1945).

[21] United States v. City of New Britain, 347 U.S. 81 (1954).

[22] New York v. Maclay, 288 U.S. 290 (1933).

liquidate its liens at the time the receiver was appointed. The state argued that under the statutes of New York the franchise taxes are liens in advance for the years in which they are due, though the amount is not fixed and must be liquidated thereafter. The Court stated that the lien was not specific in amount since no assessment had been made, and that the doctrine of relation back would not operate to divest the United States of its preference. The Court made it clear that the tax would not be entitled to priority even if the amount had been liquidated before rights and interests became static through insolvency proceedings, for there had been no change of title or possession.

The priority also prevailed over a state gasoline tax lien which by state law was declared to be a first and preferred lien prior to any and all other existing liens upon all the property of any distributor devoted to or used in his business as a distributor.[23] The Supreme Court held that the state lien was neither specific nor constant; the claim was uncertain as the audit might be incorrect, and the final amount was left for determination by the courts. It emphasized that prior to the appointment of the receiver, the state had made no move to assert its lien. The decision went on to say that once the priority of the United States had attached, it could not be divested by any subsequent proceedings in connection with the state's lien, thus reaffirming the language used by the Court in *Maclay*.[24] The Court also made it clear that the competing lienor must divest the taxpayer of either title or possession before the lien would meet the Court's standard of perfection.

The priority was held superior to a landlord's lien and a municipal tax lien in *United States v. Waddill, Holland & Flinn, Inc.*[25] The Supreme Court of the United States, in reversing the Virginia Supreme Court, stated that the landlord had only a general power over unspecified property at the date of assignment and that specificity was clearly lacking. It found the landlord's lien was not

[23] United States v. Texas, 314 U.S. 480 (1941).

[24] New York v. Maclay, 288 U.S. 290 (1933).

[25] 323 U.S. 353 (1945), *reversing* 182 Va. 351, 28 S.E.2d 741 (1944). A Virginia statute authorized the landlord to levy a distraint for six months' rent upon any goods of an insolvent lessee found on the premises, or which may have been removed therefrom not more than thirty days before the levy. The Supreme Court of Appeals of Virginia declared the statute gave the landlord "a lien which is fixed and specific, and not one which is merely inchoate, and that such a lien exists independent of the right of distress or attachment, which are merely remedies for enforcing it. 182 Va. at 363, 28 S.E.2d at 746." *Id.* at 356.

specific as to the amount of the lien, was not definite as to the property to which the lien attached and that there had been no divestiture of title or possession. The Court made it clear that federal law—not state law—controls in determining when a lien is perfected. The Court also emphasized that the competing liens must be specific and perfected before the voluntary assignment takes place. If divestiture of title or possession had occurred before the assignment, the property would not have passed to the assignee and the United States would not have had any interest in it. As was stated in the *Thelusson* case, the priority of the United States must be satisfied out of the debtor's estate. This could not have been done if the landlord had obtained possession of the property of the debtor prior to insolvency.

The Court also sustained the federal priority as against the city's personal property tax lien. The city contended that it assessed taxes on specific items of furniture pursuant to annual levies made by the city council and that a lien attached to such property on January 1, by operation of state law. The Supreme Court stated that under Virginia law the municipal tax confers a lien on personal property which enables the city to follow it wherever it may be taken only if the assessment is specifically made on such property. It emphasized that until actual distraint there was no certainty as to the property subject to the lien and no transfer of title or possession relative to any property.

In *Illinois ex rel. Gordon v. Campbell*,[26] a state lien for unemployment contributions attaching to all the employer's personal property used in his business was held inchoate by the Supreme Court. The State of Illinois asserted that the lien became specific and perfected when notice of the lien had been filed and recorded and when the receiver had been appointed. The lien attached only to personal property used by the employer "in conection with his trade, occupation, profession or business." Under these circumstances, the Court held that there was here (1) no lack of identity of the lienor, (2) no lack of specificity as to the amount of the lien, but there was (3) a lack of definiteness as to the property to which the lien attached.

Here, as in *United States v. Texas*,[27] the Court stated that the

[26] 329 U.S. 362 (1946).
[27] 314 U.S. 480 (1941).

property subject to the lien was neither specific nor constant. It went on to say that the goods subject to the lien had not severed themselves from the general and free assets of the owner from which the claims of the United States were entitled to priority of payment. "Indeed, . . . not only was the property not in the hands of the bailiff, but so far as appears the amount or type of property belonging to the debtor was not known to the state."[28] The Court concluded that the state had acquired neither title nor possession as of the crucial date, which was the date the receiver was appointed.

*United States v. Gilbert Associates*[29] involved a priority issue between the government for employment, withholding and corporate income taxes and the Town of Walpole, New Hampshire, for an ad valorem tax on certain machinery of Gilbert Associates. The United States relied on both section 3670 of the 1939 Code and on section 3466 of the Revised Statutes. In point of time the local tax assessments were prior, and the New Hampshire law provided that such assessments were in the nature of a judgment. On this basis the town contended that it was a judgment creditor within the meaning of section 3672 of the 1939 Code and that the Government's lien was not valid against the town, as the notice of federal tax lien was not filed until after the local tax lien arose. The New Hampshire Supreme Court upheld this contention.[30]

As for the argument that the town was a judgment creditor, the United States Supreme Court was careful to point out that the state of New Hampshire was free to give its interpretation for the purpose

[28] 329 U.S. at 373. One state court has regarded a lien on all the debtor's real and personal property as choate, because it requires no selection or identification. State v. Woodroof, 253 Ala. 620, 46 So. 2d 553 (1950). *But cf.* United States v. Williams, 139 F. Supp. 94 (M.D.N.C. 1956).

[29] 345 U.S. 361 (1953). The town property tax arose on April 1, 1947, and April 1, 1948. The federal taxes became due between 1943 and June 30, 1948. A lien was filed on August 6, 1948. On August 24, 1948, the town advertised the property for sale for the 1947 tax, and on September 25, 1948, the property was sold. A temporary receiver was appointed on August 12, 1949, and the town again sold the property on September 24, 1949, for the 1948 taxes. The town bid in the property at its own sales, but never took possession of the property, which was later sold by the receiver, creating the fund involved in the proceeding.

[30] Petition of Gilbert Associates, Inc., 97 N.H. 411, 90 A.2d 499 (1952). That court also held the town was entitled to priority over the United States under § 3466. It reasoned that the effect of the federal statute depends upon the status of the lien at the time insolvency occurs and that since the property had been foreclosed by advertisement and sale prior to the date of insolvency, the prerequisites for a valid prior lien had been fulfilled.

of its own internal administration, but that the interpretation of who was a judgment creditor under section 3672 of the 1939 Internal Revenue Code was for federal courts to decide. The Court said the town was not a judgment creditor because "in this instance, we think Congress used the words 'judgment creditor' in section 3672 in the usual, conventional sense of a judgment of a court of record, since all states have such courts."[31]

While the Court concluded that the town was not a judgment creditor, it did not decide whether or not the town's lien was choate as against the Government's lien under section 3670 of the 1939 Code. It would appear that a discussion of the rights of a judgment creditor in an insolvency situation was academic in light of the decision of the Supreme Court in *Thelusson,* wherein it was stated that a prior judgment creditor was to be subordinated to the United States in cases of insolvency under section 3466. The Court emphasized that " 'specificity' requires that the lien be attached to certain property by reducing it to possession, on the theory that the United States has no claim against property no longer in the possession of the debtor."[32] Since the taxpayer had not been divested by the town of either title or possession, the town had only a general, unperfected lien.

The liens in all of these cases discussed under section 3466 were inchoate for the reason that at the time the definitive act of insolvency occurred, something remained to be done to make them specific and perfected. The amount of the lien or the identity of the lienor may not have been definitely settled; necessary steps to enforce the lien may not have been taken; or no particular property of the debtor may have been segregated by title or possession from the gross assets of the debtor to which the lien attaches. In the main, the argument has resolved itself into a factual step by step analysis which leaves the conclusion that something short of payment always remains to be done to enforce any type of lien. As one court has observed[33] under this reasoning, even a mortgage is not perfected, since it too must be foreclosed to secure payment.

The requirements of the Supreme Court for a choate lien under this section are so ineluctable that it has never found a competing

[31] 345 U.S. at 364.
[32] *Id.* at 366.
[33] *In re* Meyer Estate, 159 Pa. Super. 296, 48 A.2d 210 (1946).

lien that has met these standards. As a result, the question of whether section 3466 awards priority to the Government over a prior specific and perfected lien has yet to be decided by the Supreme Court. Nevertheless, many state and lower federal courts hold the section inapplicable as against a prior specific and perfected lien.[34] The Supreme Court in the *Conard* case indicated a prior specific and perfected lien will defeat the priority. The language is even stronger in *United States v. Knott*.[35] In that case the Court said an inchoate general lien created by the laws of a state "lacks the characteristics of a specific perfected lien which alone bars the priority of the United States."[36] Therefore, it is believed that the Supreme Court will hold a specific and perfected lien defeats the federal priority if the question is ever squarely presented to it.

## II

### Section 6321, Internal Revenue Code of 1954

This concept of a perfected lien, originally evolved under the priority provisions of section 3466, has been carried over into the tax lien field. The Government's rights as a lien claimant arise for the most part from section 6321 of the 1954 Internal Revenue Code. The lien arises at the time of the assessment of unpaid taxes, unless the competing liens are entitled to the protection of section 6323 (a), which provides that the lien imposed by section 6321 shall not be valid "as against any mortgagee, pledgee, purchaser or judgment creditor" until notice has been filed as therein provided.[37] It creates a lien of sweeping application and covers all property and rights to property of the taxpayer, after acquired[38] as well as property exempt under state law.[39] It is a specific and perfected lien as of the date of assessment, notice and demand having been duly made.[40] The statute does not specify that the United States has a first lien,

[34] United States v. Atlantic Municipal Corp., 212 F.2d 709 (5th Cir. 1954); State v. Woodroof, 253 Ala. 620, 46 So. 2d 553 (1950); Ernst v. Guarantee Millwork, Inc., 93 P.2d 404 (Wash. 1939).

[35] 298 U.S. 544 (1936).

[36] *Id.* at 551.

[37] United States v. Chapman, 281 F.2d 862, 867 (10th Cir. 1960).

[38] Glass City Bank v. United States, 326 U.S. 265 (1945).

[39] Shambaugh v. Scofield, 132 F.2d 345 (5th Cir. 1942).

[40] United States v. Kings County Iron Works, Inc., 224 F.2d 232 (2d Cir. 1955); Cobb v. United States, 172 F.2d 277 (D.C. Cir. 1949); United States v. City of Greenville, 118 F.2d 963 (4th Cir. 1941).

or shall be paid first, as does the priority statute when the debtor is insolvent. At one time this absence of priority language led some courts to conclude that Congress by its silence sanctioned the right of individual states to accord the federal tax lien whatever subordinate position they desired.[41]

The initial question to be answered in a lien priority dispute involving a federal tax lien is whether, and to what extent, the taxpayer has property or rights to property to which the tax lien can attach. This is to be determined by reference to state law.[42] However, once the tax lien has attached to the taxpayer's property interest, it is the federal law that determines the priority of competing liens.[43] When the lien attaches to property of a delinquent taxpayer, it can only be defeated in two ways. Competing lienors may claim a prior choate and perfected lien entitled to precedence under the rule that "the first in time is the first in right," or they may seek to bring themselves within the classes of creditors specifically protected by section 6323 of the 1954 Internal Revenue Code.[44]

The Government was not initially as successful in urging the subordination of statutory liens competing with the federal tax lien, as it had been in urging the subordination of such liens to the section 3466 priority. The courts proceeded upon the premise that the Government's liens for taxes attached subject to the right of other lienholders. Most courts consistently applied the principle "the first in time is the first in right" and awarded priority accordingly. Where the federal tax lien was prior in time, the government won. However, where the competing non-federal lien was prior in time, the Government lost.[45] In the late 1940's, however, the Government began pressing for the application of the specific and perfected doctrine to federal tax lien litigation. The reason behind this argument by analogy was clearly to bring tax lien litigation within the rationale of section 3466 cases for the sake of uniform criteria in

[41] *In re* Mt. Jessup Coal Co., 7 F. Supp. 603 (M.D. Pa. 1934).

[42] Aquilino v. United States, 363 U.S. 509 (1960); United States v. Durham Lumber Co., 363 U.S. 522 (1960); United States v. Bess, 357 U.S. 51 (1958).

[43] Aquilino v. United States, *supra* note 42.

[44] United States v. City of New Britain, 347 U.S. 81 (1954); United States v. Kings County Iron Works, Inc., 224 F.2d 232 (2d Cir. 1955).

[45] United States v. Sampsell, 153 F.2d 731, 735 (9th Cir. 1946). The court said: "There is nothing in the Internal Revenue Code, §§ 3670-72, . . . providing for government priority over inchoate liens which antedate its own liens."

both areas. This argument was generally lost in lower federal and state courts, which were unpersuaded by the necessity of harmony.[46]

In 1950 the government carried its argument by analogy to the Supreme Court in *United States v. Security Trust & Savings Bank.*[47] The case involved a contest between an attachment lien and the federal tax lien. Certain real estate in California had been attached by a creditor of the taxpayer on October 17, 1946, and judgment was obtained on April 24, 1947. The United States filed notices of tax liens on December 3, 5, and 10, 1946. Thus, notice of the federal tax lien was recorded subsequent to the date of the attachment lien but prior to the date the attaching creditor obtained judgment. The state law provided that the lien of an attachment on real property attached and became effective upon recording a copy of the writ, together with a description attached.

In holding the attachment lien inchoate until perfected by a judgment, the Court relied solely on prior decisions under section 3466. The Court held the competing lien inchoate because it had to be enforced by a judgment within three years. In the meantime numerous contingencies might arise that would prevent the attachment lien from ever becoming perfected by a judgment awarded and recorded. The government specifically argued that the federal tax lien statute was desigued to supplement, and serves purposes comparable to section 3466 and that the tax lien should attach to the same property interests belonging to a tax delinquent as are reached by that statute.[48] The Supreme Court accepted the argument.[49] Thus, the distinction between "specific and perfected" liens and inchoate liens, which had long been used in the interpretation and application of the priority statute, was engrafted by interpretation on the tax lien statute, although that statute did not subordinate or even mention inchoate liens.

The siguificance of the *Security Trust* decision cannot be overemphasized. The language of the Supreme Court, which appears to accept the argument of the Government, set a precedent and established the rule that federal tax liens are not to be subordinated to

[46] See Kennedy, *The Relative Priority of the Federal Government: The Pernicious Career of the Inchoate and General Lien,* 63 YALE L.J. 905 (1954). This article presents an excellent historical study and analysis of the federal tax lien through 1954.

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

[48] See Felton, *Federal Tax Liens: Their Priority and Enforcement,* 10 DRAKE L. REV. 3, 13 (1960).

[49] 340 U.S. at 51.

prior inchoate liens. Thus, the court drove a wedge into the "first in time is first in right" principle. The applicable rule became "the first specific and perfected in time is the first in right."

The next case to reach the Supreme Court was *United States v. City of New Britain.*[50] The question presented involved the relative priority of federal and municipal liens to the proceeds of a mortgage foreclosure sale of the property to which the liens attached. The competing liens involved were for delinquent real estate taxes and water rents which attached to specific real property. The federal tax liens, the real estate tax liens, and the water rent liens arose from time to time at various dates over a period of several years.

The law of Connecticut, where the case arose, provided that real estate liens would take preference over all transfers and encumbrances affecting the property subject to the lien. The water rents, by state law, were given "precedence over all other liens or encumbrances except taxes." The local courts agreed that the liens were specific and perfected and that the city's liens were entitled to priority over the United States. The Supreme Court held, on the basis of the rules established in the cases under section 3466 and the *Security Trust* case, that the characterization of the local tax liens as specific and perfected was not conclusive on the federal government; but it accepted "the holding as to the specificity of the City's liens, since they attached to specific pieces of real property for the taxes assessed and the water rent due," and added that "the liens may also be perfected in the sense that there is nothing more to be done to have a choate lien—when the identity of the lienor, the property subject to the lien, and the amount of the lien are established."[51]

The Court held the city's liens were perfected since they attached to specific pieces of real property. There was no doubt as to which property the liens attached. The lienor could meet the requirement of specificity as to property without title or possession. The Court explicitly affirmed the specific and perfected doctrine as being applicable to liens competing against the federal tax lien. While the Court accepted the state court's holding as to the choateness of the liens, it did not determine the date on which they became choate. The question as to when the amount became specific still had to be determined.

[50] 347 U.S. 81 (1954).

[51] *Id.* at 84.

This is the first occasion on which the Supreme Court concluded that competing liens were choate. In comparing this case with *Security Trust* and others decided under section 3466, it is important to observe that the Supreme Court noted these liens were on specific realty and that the United States was free to pursue the whole of the debtor's property wherever situated. The state, having a lien only upon property within its boundaries, may not reach beyond the state line to fasten its lien upon other property. The contingency or possibility of removal of personalty from the state may, to some extent, result in a conclusion of inchoateness; whereas, obviously real estate cannot be removed and real estate taxes are definitely fixed as to amount at some fixed date, and the identity of the lienor is established, as is the property subject to the lien.

As between the city's liens and the federal tax liens, the Court followed the legal principle "the first in time is the first in right." Of course, this principle is only applicable when the competing liens are choate. Thus in *New Britain* the Court made explicit what was implicit in *Security Trust*. The Court made no mention of the requirement that the competing lienor have title or possession. Yet, it stated their decision was not inconsistent with the *Gilbert Associates* case. In that case the Court stated that the taxpayer must be divested of possession and concluded that the town's lien was general and unperfected. In *New Britain* the city had not reduced its lien to title or possession, yet had a choate lien. The Court resolved this difference by distinguishing *Gilbert Associates* on the grounds that it involved personalty and insolvency.

The Court's disregard of what had been a fatal defect in competing liens where section 3466 was applicable suggests a difference in the application of the choate lien doctrine to section 6321 cases. Yet, it must be remembered that the Supreme Court has never decided a case involving section 3466 where the competing lien was on specific real property. Entirely apart from the merits of the divestment requirement, it is submitted that the prerequisites to the existence of a choate lien should be the same in both the tax lien and priority statute cases. The whole concept is judicial gloss resulting from the interpretation and correlation of the two statutes. Having created the choate lien standard the court should apply an identical criteria in the two types of cases.

The Supreme Court remanded the *New Britain* case back to the

Supreme Court of Errors of Connecticut for that court to determine the order of priority of the various liens asserted. In determining priority the court in *Brown v. General Laundry Service*[52] held that the lien of the city for real estate taxes depends not necessarily upon when the state statute might say it arises, but, when in fact it becomes choate. The city claimed that the assessment date of October 1 was the date the lien became choate. The court said the lien was not choate until the tax rate was set and that this was not done until the January following the assessment date.

Thus, where a tax rate must be established by an assessment board or council after the valuations have been made, it appears that the local tax lien does not become fixed in amount until the rate has been conclusively established. This is a sound rule if the liens are to meet the conditions of choateness as established in the *New Britain* case. Where a tax is on specific real property, the requirements for choateness will be met whenever the tax rate is established by an assessment board or council. It is only then that the tax can be definitely ascertained.

The *Security Trust* case was followed in *United States v. Acri*,[53] which arose in Ohio and involved an attachment lien. The tax lien arose and the notice was filed subsequent to the attachment but before the judgment. The fact that under state law the attachment lien was designated as "an execution in advance" and treated as a perfected lien at the time of the attachment did not make the lien choate. The Supreme Court held the attachment lien inchoate, saying: "We hold here that the attachment lien in Ohio is for federal tax purposes an inchoate lien because, at the time the attachment issued, the fact and the amount of the lien were contingent upon the outcome of the suit for damages."[54] In both the *Security Trust* and *Acri* cases, the attachment liens were in essence held to be no more than a *lis pendens* notice that a right to perfect a lien existed, a caveat of a more perfect lien to come and, thus, contingent and inchoate since at the time the attachment issued, the fact and the amount of the lien were contingent upon the outcome of the suit for damages.

[52] 19 Conn. Supp. 335, 113 A.2d 601 (1955). See also Streeter Bros. v. Overfelt, 202 F. Supp. 143 (D. Mont. 1962), where the court followed the same reasoning.

[53] 348 U.S. 211 (1955), *reversing* 209 F.2d 258 (6th Cir. 1953), which affirmed 109 F. Supp. 943 (N.D. Ohio 1952).

[54] *Id.* at 214.

As in the case of attachment, a garnishment under state law which is dependent for perfection upon obtaining a judgment and the issuance of execution in the related action is subordinate to the federal tax lien.[55] Thus, it seems that attachment or garnishment proceedings are merely notices to acquire a lien yet to arise and therefore are inchoate; that they are contingent interests which are not determined until judgment; that even judgments are not enough where state law requires more to be done to secure a judgment lien. This latter requirement has long been recognized by the federal courts.[56] A creditor with a garnishment or attachment lien is not able to eliminate the contingent nature of his claim prior to judgment. A judgment would, however, fix the amount of the lien on the debt owed by the garnishee because the doctrine of res judicata would bar any later attack on the amount of the lien by the debtor.

In *United States v. Scovil*[57] a landlord's distress lien for rent was held inchoate because state law provided that the tenant might put up a bond and free the property from the distress lien and reacquire any interest the landlord may have had in the property. Notice of the federal tax lien was filed on April 10, 1952, but the assessments were made in 1951 and in February, 1952, prior to the landlord obtaining a distress warrant. The state court held that notice of the Government's tax lien had to be filed in order to be good against a landlord's lien which had been perfected. It reasoned that a perfected landlord's lien made the landlord a purchaser. The Supreme Court rejected this reasoning by saying that the landlord was not a purchaser, for such "usually means one who acquires title for a valuable consideration in the manner of vendor and vendee."[58]

The Government's tax liens arose long before the landlord ob-

[55] United States v. Liverpool & London & Globe Ins. Co., 348 U.S. 215 (1955), *reversing* 209 F.2d 684 (5th Cir. 1953), which affirmed *sub nom.* Sunnyland Wholesale Furniture Co. v. Liverpool & London & Globe Ins. Co., 107 F. Supp. 405 (N.D. Tex. 1952). The garnisher had attached insurance proceeds due the debtor before the assessment lists had been received in the office of the District Director, but the tax lien was filed and notice thereof with warrants of distraint and levy was served on the garnishee before the garnisher's claim was reduced to judgment. Since the garnisher had not reduced his claim to judgment, the amount was not definitely determinable. Thus, the standards of a choate lien were not met.

[56] Ersa, Inc. v. Dudley, 234 F.2d 178 (3rd Cir. 1956); Miller v. Bank of America, 166 F.2d 415 (9th Cir. 1948); Beeghly v. Wilson, 152 F. Supp. 726 (N.D. Iowa 1957); United States v. Record Pub. Co., 60 F. Supp. 194 (N.D. Cal. 1945).

[57] 348 U.S. 218 (1955).

[58] *Id.* at 221.

tained a distress warrant. Since the landlord was not a purchaser, there was no need for a notice of the tax lien to be recorded. Under these circumstances the landlord would have only been entitled to priority if he had possessed a choate lien prior to the date the assessments for taxes were made. Taxes were assessed on March 19, 1951, May 24, 1951, August 29, 1951, December 3, 1951, February 23, 1952, and February 28, 1952. The rent was for the months of February, March, and April, 1952. The tax liens had all attached to the tenant-taxpayer's property before the rent for March and April had become due. These facts make it apparent that the landlord's lien could not even satisfy the requirement that the amount be specific prior to the time the federal tax liens arose. Moreover, the landlord's lien was general in the sense that it only attached to property that might be on the rented premises at the time the distress warrant was issued. Until the distress warrant was issued the landlord had no way of knowing exactly what property was available to pay the rent.

There is no doubt that the landlord's lien was inchoate at the time the tax liens arose, but the language of the Court goes even further in saying that the landlord's lien was inchoate at the time notice of the tax liens was filed. Once the Court found filing notice of the tax liens was unnecessary, it would seem there was no need to hold the lien inchoate as of that date. If the landlord had already taken possession of the property by distraint, then the language of the Court must be interpreted to mean that irrevocable title or possession is required before such liens can be perfected. The landlord could not have sold the property until the tenant had failed to give bond.

The most striking application of the doctrine of perfected liens applies in the mechanic lien field. Here, unless the laborer or materialmen can show that the delinquent taxpayer had no state-created property rights under the *Durham Lumber Co.*,[59] *Aquilino*,[60] and *Chapman*[61] decisions, it is virtually impossible for him

[59] United States v. Durham Lumber Co., 363 U.S. 522 (1960). The Supreme Court deferred to the fourth circuit in allowing the claims of subcontractors against the claims of the United States for taxes of the main contractor, upon the theory that under North Carolina law the main contractor had "no property interest" except in the surplus remaining after the subcontractors were paid.

[60] Aquilino v. United States, 363 U.S. 509 (1960). The Court implied the subcontractor would prevail over the tax lien if, under local law, payments received by the

to prevail upon the lien priority basis. The Supreme Court has decided four[62] mechanics' lien cases, all by per curiam opinion which provide no direct answer or explanation to the problem of choateness. In *White Bear*,[63] which is representative of all these cases, the priority of the federal lien was extended over a statutory mechanic lien, where the mechanic's work had been completed, notice of his mechanic lien had been duly filed in strict compliance with state law and foreclosure proceedings on the lien were actually pending in the state court, all before the tax lien arose by assessment. All that was lacking was a final judgment enforcing the mechanic's lien which would set at rest any possibility of controversy over the amount owing. In a dissent Justices Douglas and Harlan stated they would apply "the first in time is first in right" principle stated in *New Britain* and hold the competing mechanic lien was specific and choate.[64]

In all the mechanic lien cases decided by the Supreme Court, the private lienor was identifiable and the property was easily identified, since the lien attached to the particular property that was improved. The amount was presumably the outstanding balance, but the Supreme Court made it clear that the amount was not definite until it was reduced to judgment. The liens were inchoate since no judgment had been obtained and the later federal tax liens prevailed. Perhaps the theory of the Court was that the mechanic's lien was not a property right, but only a substitute for a property right or an intent to assert a property right. Apparently the Court believed the improved property, although created by the mechanics, was property

prime contractor were held in trust for subcontractors to the extent of the latter's claim.

[61] United States v. Chapman, 281 F.2d 862 (10th Cir. 1960). The court stated that under the law of forum, the failure of the contractor to perform the condition precedent of proving payment of all labor and materialmen's claims negated the possibility of his acquiring any property or rights to property in the retained percentage. The construction contracts required the contractor to prove satisfaction of all labor and material claims before being paid a retained percentage of the contract price.

[62] United States v. Hulley, 358 U.S. 66 (1958), *reversing* 102 So. 2d 599 (Fla. 1958); United States v. Vorreiter, 335 U.S. 15 (1957), *reversing* 134 Colo. 543, 307 P.2d 475 (1957); United States v. White Bear Brewing Co., 350 U.S. 1010 (1956), *reversing* 227 F.2d 359 (7th Cir. 1955); United States v. Colotta, 350 U.S. 808 (1955), *reversing* 224 Miss. 33, 79 So. 2d 474 (1955).

[63] United States v. White Bear Brewing Co., *supra* note 62.

[64] *Id.* at 1011. The dissent concluded: "The court apparently holds that under 26 U.S.C. § 3670 a lien that is specific and choate under state law, no matter how diligently enforced, can never prevail against a subsequent federal tax lien, short of reducing the lien to final judgment." *Ibid.*

"belonging to" the taxpayer, within the meaning of the tax lien law; and that the mechanic's lien was not a choate right in that property but only an opportunity to obtain a property right by completing enforcement action. Thus, it seems that no statutory mechanic or materialman's lien can be deemed an interest in property until it has been reduced to judgment.

Prior to 1958 the choateness test and its strict application had combined to award priority to the Government, first in cases involving insolvency of the taxpayer and then in tax lien cases where the competing lien was statutory in nature. In the *R. F. Ball* case[65] a new element was introduced—the contractual lien. Ball Construction Company had contracted to construct a housing project in San Antonio, Texas. On July 17, 1951, it entered into a subcontract with Jacobs for certain work which required Jacobs to furnish to Ball a surety bond, guaranteeing performance of the subcontract. On July 21, 1951, Jacobs, to induce respondent United Pacific Ins. Co. to sign the bond as surety, assigned to the surety all sums due or to become due under the subcontract, as collateral security to the surety for any liability it might sustain under its bond through nonperformance of the subcontract, and for "the payment of any other indebtedness or liability" of the subcontractor to the surety "whether heretofore or thereafter incurred."

On April 30, 1953, a balance of $13,228.55 became due from Ball under the subcontract, but because of outstanding claims of materialmen against Jacobs, Ball did not pay the debt. In May, June, and September, 1953, the District Director of Internal Revenue filed notices of federal tax liens against Jacobs totaling $17,010.85. Between December, 1953, and March, 1954, Jacobs incurred indebtedness, independent of the subcontract, to the surety in the amount of $12,971.88. The surety, contending that its assignment of July 21, 1951, constituted it a "mortgagee," claimed priority of right to the fund since notice of the federal tax liens had not been filed prior to the date of the assignment.

The Supreme Court rendered a per curiam decision holding the surety had only an inchoate interest and that the provisions of section 3672 did not apply. It cited the *Security Trust* and *New Britain*

[65] United States v. R. F. Ball Const. Co., 355 U.S. 587 (1958), *reversing* 239 F.2d 384 (5th Cir. 1956), which affirmed 140 F. Supp. 60 (W.D. Tex. 1960). Both lower courts had held the assignee to be a "pledgee" or "mortgagee," protected by what is now § 6323(a) of the 1954 Code.

decisions as authority. Justice Whittaker wrote the opinion for the four dissenters. He stated *New Britain* and *Security Trust* were not applicable and that the assignment constituted a mortgage in the ordinary and common law sense. He pointed out that the state law of Texas made such assignment a valid mortgage and that while the relation of a state created right to federal laws for the collection of federal taxes is a federal question, the state's classification of state-created rights must be given weight. He believed the assignment was in legal effect a mortgage, completely perfected on its date, in all respects choate, and valid between the parties. Since it antedated the filing of notices of the federal tax liens, he believed it was expressly made superior to those liens by the terms of what is now section 6323 of the 1954 Internal Revenue Code. However, the majority obviously possessed the opinion that an assignee for security of an undetermined, contingent amount, who had contemporaneously advanced no money, was not a "mortgagee" within the meaning of that section.

The lien was inchoate even though the taxpayer's property rights were completely assigned as collateral security to the surety on the bond, in full compliance with state law, and long before the federal tax liens arose. At the time of the assignment, Ball was not indebted to the assignor-taxpayer. In effect the assignment was not of accounts presently receivable, but of accounts to become receivable under an executory contract, which was contingent on Ball becoming indebted to the taxpayer on the contract. Furthermore, the amount of the lien, though completely incurred and utterly inescapable, had not become fixed and definite in amount. By the assignment, the taxpayer not only secured the full performance of his agreements under a bond, but he also secured "the payments of any other indebtedness or liability . . . whether heretofore or hereafter incurred . . . ." Therefore, it would appear the lien was inchoate on two grounds. The property right assigned was not specific and constant and the amount of the lien was contingent and uncertain. This would appear to be in complete harmony with previous decisions of the Court.

In the recent case of *Crest Finance Co. v. United States*[66] the Court was again confronted with a contractual lien competing against the federal tax lien. Crest Finance loaned money to the taxpayer-

[66] 368 U.S. 347 (1961), *reversing* 291 F.2d 1 (7th Cir. 1961), which affirmed *sub nom.* United States v. Standard Paving Co., 60-2 U.S. Tax Cas. ¶ 9774 (N.D. Ill. 1960).

subcontractor from March 21, 1958, through June 10, 1958, and received several promissory notes secured by assignments of accounts receivable. The accounts receivable were in existence and owed at the time of the assignments. They consisted of periodic progress payments then owed by the principal contractor to the taxpayer, but which at the time were not collectible. The notes provided that the accounts were pledged as security, and the assignment instruments included a schedule of assigned accounts which listed the specific account assigned.

On August 15, November 7, and November 14, 1958, the District Director made an assessment for federal withholding and social security taxes against the taxpayer-subcontractor. At the time of the assessment, the principal contractor was indebted to the taxpayer and the United States served a notice of levy on them on October 9, 1958. The principal contractor filed an action for interpleader and paid the account due into the registry of the court.

Crest claimed priority on two grounds: (1) that it was a pledgee and entitled to the protection of section 6323; and (2) that its liens, based on the assignments of the taxpayer's receivables were choate prior to the filing of the notice of the tax lien according to the standards set forth in *New Britain*. The court of appeals, affirming the district court decision, inexplicably found it unnecessary to determine whether the lender was a pledgee under section 6323, but stated that it was required under previous Supreme Court decisions to hold that Crest's liens were not perfected. To reach this result the Court did little more than state its decision was controlled by the *Ball* case and three cases which followed it.[67] It further reasoned that the fact the assignment was to secure a present and existing indebtedness, as opposed to a future or contingent indebtedness in *Ball* would not make an otherwise unperfected lien choate.

The Supreme Court reversed the circuit court on the choate lien question and remanded the case for a determination of whether

[67] United States v. Chapman, 281 F.2d 862 (10th Cir. 1960); Arthur Company v. Chicago Paints, Inc., 175 F. Supp. 50 (D. Minn. 1959); First State Bank v. United States, 166 F. Supp. 204 (D. Minn. 1958). In both the *First State Bank* and *Chapman* cases, it was argued that the assignment in *Ball* was given to secure a contingent or future indebtedness and that the assignments under consideration by those courts were given to secure a present and ascertained indebtedness. The court in *First State Bank* discredited this by saying it was a distinguishing characteristic but that the distinction did not perfect an unperfected lien. This language was also followed in *Chapman*. The reasoning of those courts is somewhat fallacious in view of the fact that this was one of the reasons the Supreme Court in *Ball* seems to have held the lien inchoate.

or not the assignments of the accounts receivable were valid under state law without recordation. The Solicitor General conceded the liens were choate if the assignments were valid under state law without recordation. On remand,[68] the court of appeals held no recordation was necessary and that the liens were choate.

The decision indicates that there is a distinction between an assignment for a present and existing indebtedness as opposed to one for a future or contingent indebtedness. In *Ball* the amount of the indebtedness was not fixed by the time the tax lien arose; whereas, in *Crest* the indebtedness could be definitely determined prior to the time the first tax lien came into being. Furthermore *Crest* would seem to indicate that where assignments, which are valid under state law, of present and existing accounts receivable are made as security for a loan, the property subject to the lien is specific. The assignment in *Ball* was not of accounts presently receivable, but of accounts to become receivable. Thus, it would seem that any contractual lien which results from an assignment of present and existing accounts receivable, or other security, for a present and existing indebtedness will meet the strict standards of choateness.

## III

### Conclusion

The choate lien doctrine is one of the most misunderstood and misquoted principles that has ever been construed by the Supreme Court. Many courts simply do not understand the requirements of a choate lien; others feel it is too harsh and refuse to follow it; still others resolve the conflict without mentioning or discussing the pivotal factors which must be taken into consideration in determining whether the federal standards of choateness were actually satisfied. In deciding in favor of a given local lien, they have been content to set out an unsupported conclusion ascribing choateness to the local lien as of a certain date.

Generally speaking, the identity of the lienor rarely causes any difficulty in ascertaining whether or not a lien is choate. The requirement that the amount be specific presents a much greater hazard to the competing statutory lienor. It seems clear that a statutory lien which must be enforced with the aid of the courts can

[68] 302 F.2d 568 (7th Cir. 1962).

not be accorded priority over a subsequently arising federal lien or the federal priority in insolvency, unless there has been a final judgment setting at rest any possible controversy over the amount that is owed. Statutory liens which are enforceable by levy and sale, without having to go to court, are also affected by the requirement that the amount of the lien be certain. The amount must be fixed by assessment and the administrative remedies for contesting it must be exhausted or foregone before the amount can be definitely determined. Therefore, in order for any competing statutory lien to be definite in amount, it must be fixed beyond any possibility of administrative or judicial review.

Where the competing lien is contractual, it is somewhat easier to comply with the requirement that the lien be specific in amount. The *Crest* decision implies that any lien for a present and existing indebtedness, as opposed to a contingent and undetermined amount, will meet the requirement. If this be the case, it would seem that where future as well as present advances are made, the creditor or lender, with reference to the future advances, will be able to meet the requirement of specificity of amount if the future advance is actually made before the federal lien arises. Under these circumstances, a definite amount of present and existing indebtedness can be ascertained prior to the time the federal tax lien arises.

Once the lien is specific in amount, it still must meet a stringent application of the standard of identification of the property subject to the lien. In some instances this not only means that the property must be identified, but also that it must be reduced to title or possession. The *New Britain* and *Crest* decisions make it clear that divestiture of title or possession is not required when taxes are on specific real property, or the competing lien is contractual in nature and valid under state law against third parties. However, if a contractual lien does not name specific property which is in being at the time of the assignment and is constant, it is doubtful it can be regarded as choate. The specificity of property standards will probably not be met where the property in question is a changing rather than a constant mass. Furthermore, it seems doubtful that a general lien on all the taxpayer's property will be recognized as choate unless it is reduced to title or possession. In most instances such liens will require selection and until distraint is made by the competing lienor, he does not know what propetry is available to pay

the lien. Consequently, it is believed that in cases where the competing liens are not taxes on real property or contractual in nature, they will not prevail over the federal tax lien or insolvency priority unless the debtor has been divested of title or possession before the tax lien or insolvency arises.

Much of the confusion surrounding the choate lien doctrine probably evolves from the failure to recognize that while the three requirements for determining a choate lien must always be met, they do not remain uniform in their application to all competing liens. For instance, certain competing lienors must reduce their liens to judgment in order to be specific in amount, while others do not have to obtain a judgment to meet the requirement. The requirement that the lien attach to specific property is satisfied in some cases without the property being reduced to title or possession, while in others title or possession of the property is necessary. This lack of uniformity results because the concept of "choateness" varies under differing circumstances. The various definitions rest heavily on the nature of the lien itself and the circumstances in which the lien arises. Due to these factors, it is impossible to state any hard and fast rules that are applicable in all cases. Each case must be resolved by a factual step by step determination.