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Bankruptcy—Failure of Federal Tax Lien.—City of New York v. United States

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CASE NOTES

Bankruptcy—Failure of Federal Tax Lien.—*City of New York v. United States.*[1]—An involuntary petition in bankruptcy was filed against a faltering Company by creditors claiming unpaid wages. Prior to and within four (4) months of the petition in Bankruptcy an assignment for the benefit of creditors had been made and perfected by the debtor in accordance with the State's statutory provisions. Subsequently, and again prior to the date of the petition in bankruptcy, the Federal Government assessed tax deficiencies against the debtor and claimed lien status for these assessments under § 67(b) of the Bankruptcy Act.[2] These claims were opposed by the other creditors including the City of New York and the State of New York, who also were tax creditors of the debtor. The referee in bankruptcy and the District Court[3] upheld the Federal Government's lien status but the Court of Appeals reversed and remanded. HELD: The Federal Government was not entitled to lien status on assessments made after such general assignment even though the assignment was made within four (4) months of the filing of the bankruptcy petition in view of the fact that a Federal tax lien attaches to property belonging to a debtor, and under New York law the debtor did not have any property after his general assignment.

The Court rejected the appellee's contention that State property law was preempted by § 70(a)(8)[4] of the Bankruptcy Act which recites that the title to property held by an assignee for the benefit of creditors shall vest in the trustee in bankruptcy by operation of law at the time of the filing of the petition, the assignee being deemed the agent of the debtor, since this section would not be construed to apply retroactively from the date of the petition. In so holding the Court looked to the applicable state law to determine what property rights remained in the debtor after his assignment for the benefit of creditors to determine the effect of the Federal Government's tax lien which by the statute[5] attaches to the taxpayer's property at the moment of assessment. The Court reiterated a point previously emphasized that the tax lien statute[6] "created no property rights but merely attaches consequences, federally defined, to rights under State law".[7] Under applicable New York Law[8] an assignee for the benefit of creditors was deemed to have taken the debtor's title and to have held it in trust for all the creditors, so that after the assignment and prior to the Federal Government's perfection of its tax lien, the debtor had relinquished that to which the lien could attach. Accordingly Paragraph 67 sub b. of the Bankruptcy Act[9], which would up-

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1 283 F. 829 (2d Cir. 1960).

2 30 Stat. 550 (1898), as amended, 11 U.S.C. § 107(b) (1958).

3 180 F. Supp. 214 (E.D.N.Y. 1960).

4 11 U.S.C. § 110(a)(8) (1958).

5 Int. Rev. Code of 1954, §§ 6321, 6322.

6 Supra note 5.

7 United States v. Bess, 357 U.S. 51, 55 (1957).

8 Brown v. Guthrie, 110 N.Y. 435, 18 N.E. 254 (1888); Brennan v. Wilson, 71 N.Y. 502 (1877).

9 Supra note 2.

hold statutory liens for taxes and debts to the Government even though arising and perfected while the debtor was insolvent and within the four (4) months period prior to the filing of the petition, would not assist the Federal Government's position because of the failure of debtor property to which the lien could attach.

It is interesting to ponder the significance of this case in view of recent determinations in this area. It has been well settled by the Supreme Court that the determination of priority of liens was entirely a Federal question and that regardless of the State's characterization of their liens, the determinations would be subjected to the "choateness" test of the Supreme Court.[10] This approach protected the Federal Government's lien from those prematurely perfected by the State. This "federal question" of determining the priority of liens was dependent upon the basic assumption that the debtor had property to which a lien could attach and the question of what "property or property rights" existed was entirely considered a State determination. In *United States v. Bess*[11] the Court upheld the Federal Government's lien on the proceeds of an insurance policy to the extent of its cash surrender value, as against the beneficiary, since State law defined that the insured had such property rights in the policy during his lifetime when his taxes were assessed, even though the State law prescribed immuntiy from such levying as against the beneficiary. In *United States v. Durham Lumber Company*[12] the Court remained consistent to its holding in *Bess* and prevented the Federal Government from prevailing over a creditor sub-contractor of the taxpayer general contractor. Under State law the creditor sub-contractor could reach directly the funds owed to the general contractor by the owner of the constructed property and such was determined to have stripped the general contractor of his property rights prior to the assessment and attachment of the Federal lien, thus removing the property to which the lien could attach. The nature of the shift in the property interests is defined in *Durham* and its companion case *Aquilino v. United States*[13] as one of "constructive trust" wherein the debtor general contractor holds for the benefit of the creditor sub-contractors. Justice Harlan's dissent in the *Aquilino* and *Durham* cases[14] expresses concern over the classification of the position of a creditor as that of a property holder in those situations where the incidents of ownership remaining in the debtor or being transferred to a creditor can not be distinguished from the secured position of a lienor, and also over the possibility that unless some

[10] United States v. Hulley, 358 U.S. 66 (1958); United States v. Ball Construction Co., Inc., 355 U.S. 587 (1958); United States v. Vorreiter, 355 U.S. 15 (1957); United States v. White Bear Brewing Co., 350 U.S. 1010 (1956); United States v. Colotta, 350 U.S. 808 (1955); United States v. Scovil, 348 U.S. 218 (1955); United States v. Liverpool and London Globe Ins. Co., Ltd., 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. Security Trust and Savings Bank, 340 U.S. 81 (1950).

[11] Supra note 7.

[12] 363 U.S. 522 (1959).

[13] 363 U.S. 509 (1959).

[14] 363 U.S. at 516.

Federal standard is applied there would be nothing to prevent the States from frustrating Federal tax liens by statutorily labeling what now is characterized a lien as a property transfer from debtor to creditor.

The *Durham* classification could equally have satisfied the definition of a lien in the nature of a "mechanic's lien" which by virtue of § 67 of the Bankruptcy Act[15] would be valid even though made while the debtor was insolvent and within four (4) months of the petition of Bankruptcy, but would have been subjected to the Federal standard of "choateness" in order to qualify as a prior lien with respect to the Federal tax lien. However, since such transmutation was characterized by the State, or by the Federal Court's interpretation of the State law, as a property transfer, the Court never reaches the Federal question of the priority of liens. The Court in the *Durham* case accepted the State law determination as not unreasonable but failed to discuss the merits of the characterization. It cannot be determined from the cases what standard of reasonableness, if any, the Court is applying when viewing State property classifications but it would not be too conjectural to anticipate an amendment to the Bankruptcy Act defining exactly what property classification will be reasonable, based probably on a standard of "ownership incidents," if State law should develop so as to frustrate the Federal tax lien. However, even if such an eventuality were to transpire, an assignment for the benefit of creditors, as in the instant case, should most readily satisfy any reasonable standard.

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Banks—Forged Checks—Recovery by the Drawee Bank.— ***Mechanics National Bank of Worcester v. Worcester County Trust Company.***[1]— On September 9, 1952, an unknown man presented a $3940 check to a teller at the defendant Worcester County Trust Company (hereinafter referred to as the Trust Co.). The check, dated September 5, 1952, was drawn on the plaintiff National Bank of Worcester (hereafter referred to as National), payable to "cash" and signed "Anthony A. Borgatti." It was indorsed "Ralph Scola." The stranger also presented a deposit slip in the amount of $340 in the name of Ralph Scola, which was the name of one of the Trust Co.'s depositors. The indorsement and the deposit slip signatures were not in the same handwriting and the "S" in "Scola" had been scratched over. The Trust Co.'s teller took the check and deposit slip from the stranger without requiring identification and without comparing the signatures with the signature of Scola in the files. National's bookkeeper informed the Trust Co.'s teller by telephone that National had no account in the name of the drawer but had one in the name of "Brigida Borgatti, Conservator for Antonio Borgatti." The teller then credited Scola's account with the $340

[15] 30 Stat. 564 (1898), as amended, 11 U.S.C. § 107 (1958).

[1] 170 N.E.2d 476 (Mass. 1960).