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REAL PROPERTY – RELATIVE PRIORITY OF LIENS – FEDERAL TAX LIEN PRIORITY: A JUDICIAL FRANKENSTEIN

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In the recent case of *United States v. Vorreiter*,[1] the Colorado Supreme Court added its voice to the growing chorus of state[2] and federal[3] court dissatisfaction with the United States Supreme Court's absolutism in according federal tax liens priority over all types of state liens.[4]

In the *Vorreiter* case, one Price, a resident of Texas, contracted with Vorreiter, a Colorado resident, for the improvement of Price's Colorado realty. Prior to the making of this contract, the Collector of Internal Revenue in Austin, Texas, received assessment lists for taxes owed by Price to the United States. The Internal Revenue Code has long accorded the United States a general lien for unpaid taxes.[5] Under the 1939 code, which governed, the tax lien arose at the time the Collector received the assessment list[6] and attached to all property of the taxpayer,[7] but was invalid against "any mortgagee, pledgee, purchaser, or judgment creditor"[8] unless recorded in the office designated by state law. In the instant case, notice of the federal lien was not filed in Colorado until after Vorreiter had completed work under his contract and had filed a mechanics' lien notice against Price's property. The Colorado statute[9] grants the mechanics' lien superiority over all prior and subsequent unrecorded liens of which the mechanic's lien claimant has no notice.

In an action to foreclose the mechanics' lien, the Colorado Supreme Court found the subsequently arising but prior recorded mechanics' lien superior to the federal tax lien. The court reasoned: (1) To give the federal tax lien priority would be to negate a settled rule of Colorado property law, (2) The federal tax lien attaches only to property owned by the taxpayer at the time the lien arises. (3) To allow the Government to appropriate the inhanced value of

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[1] 307 P.2d 475 (Colo. 1957).

[2] *E.g.*, United States v. Colotta, 79 So.2d 474 (Miss.), *rev'd per curiam*, 350 U. S. 808 (1955).

[3] *E. g.*, United States v. White Bear Brewing Co., 227 F.2d 359 (7th Cir. 1955), *rev'd per curiam*, 350 U. S. 1010 (1956).

[4] For excellent treatments of this whole problem, see Reeve, *The Relative Priority of Government and Private Liens*, 29 Rocky Mtn. L. Rev. 167 (1957); Kennedy, *The Relative Priority of the Federal Government: The pernicious Career of the Inchoate and General Lien*, 63 Yale L. J. 905 (1954).

[5] The Internal Revenue Code of 1939, which governed the *Vorreiter* case, provided:

"§ 3670. Property subject to lien. 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 thereto, whether real or personal, belonging to such person." Cf. Int. Rev. Code of 1954, § 6321.

[6] "§ 3671. Period of lien. ". . . (T)he lien shall arise at the time the assessment list was received by the collector and shall continue until the liability for such amount is satisfied or becomes unenforceable by reason of lapse of time." Cf. Int. Rev. Code of 1954, § 6322.

[7] See note 6 *supra*.

[8] "§ 3672. Validity against mortgagees, pledgees, purchasers and judgment creditors. (a) *Invalidity of lien without notice*. Such lien shall not be valid against any mortgagee, pledgee, purchaser or judgment creditor until notice has been filed by the collector. . . ."

[9] Colo. Rev. Stat. Ann. § 86-3-6 (1953).

the taxpayers' property would be to confiscate the work and materials of the mechanics' lienor to pay the taxes of another, contrary to the doctrine of unjust enrichment. (4) Chief Justice Moore, specially concurring, asserted that the federal statutory exception protecting mortgagees, pledgees, purchasers and judgment creditors without notice, should be broadened by interpretation to include mechanics' lienors.[10]

The result in the principal case directly contravenes the construction the United States Supreme Court has given the tax lien created by section 3670 of the 1939 code. As a review of its reasoning will demonstrate, the Colorado court pointedly omitted mention of this long standing construction and the cases in which the United States Supreme Court established it.

(1) *Settled Rule of Property.* The cases cited by the Colorado court to support its contention that the United States Supreme Court will defer to state decisions which establish a settled rule of property within that state, are clearly inapplicable.[11] Indeed, *United States v. Snyder*,[12] the first Supreme Court decision to construe the predecessor of section 3670,[13] manifested no hesitation in invalidating a Louisiana recording statute which would have defeated the federal lien as an unrecorded lien.[14] Moreover, the Constitution's recitation of the federal power to tax,[15] when considered with the supremacy clause,[16] seems decisive.

(2) *Property Affected by the Tax Lien.* The Colorado court's theory that the federal lien attaches only to property owned by the taxpayer when the lien arises is inconsistent with the *Glass City Bank case*.[17] There the United States Supreme Court held that the federal tax lien applies to any property owned by a taxpayer at any time during the life of the lien, although acquired after the lien arises.

(3) *Unjust Enrichment—Payment of Another's Taxes.* The Colorado court's contention that awarding the federal tax lien priority would unjustly enrich the United States, and, in effect, require the mechanics' lienor to pay another's taxes, has great merit. The Supreme Court, however, has consistently ignored this argument. In point is the above mentioned *Snyder* case which involved a tobacco tax lien upon land. After the tax lien arose, the land was conveyed to a good faith purchaser who had no notice of the lien. When *Snyder* arose, the federal lien statute contained no provision invalidating an unrecorded tax lien against "purchasers."[18] The question presented was whether the federal lien could be defeated by a state recording statute. The answer, of course, was negative, and the tax lien was foreclosed against the good faith purchaser.

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[10] 307 P.2d at 479.

[11] The Colorado court cited Edward Hines Yellow Pine Trustees v. Martin, 268 U. S. 458 (1925); Warburton v. White, 176 U. S. 484 (1899) and Burcher v. Cheshire R. Co., 125 U. S 555 (1888), none of which concerned matters of taxation or lien priorities.

[12] 149 U. S. 210 (1893).

[13] Rev. Stat. § 3186 (1878), *as amended*, 20 Stat. 327, 331 (1879).

[14] La. Const. art. 176 (1879).

[15] U. S. Const. art. I, § 8, subs. 1; U. S. Const. amend. XVI.

[16] U. S. Const. art. VI, § 2.

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

[18] 20 Stat. 327, 331 (1879), *amended*, 37 Stat. 1016 (1913), (lien made invalid without notice against mortgagees, purchasers or judgment creditors), *amended*, 45 Stat. 875 (1928) (added pledgees to those protected from unrecorded lien).

Following this severe precedent, the Supreme Court has frequently applied the theory that the federal tax lien statute creates a secret, general lien[19] valid, without regard to notice, against all subsequent lienors who cannot bring themselves within the enumerated exceptions.[20] Moreover, where it has appeared that a state lien was first in time to the federal tax lien, the Court has gone to great lengths to find an "imperfection" in the state lien sufficient to defeat its priority.[21] Although in the *Vorreiter* case, the Colorado mechanics' lien did not even enjoy the dubious distinction of being first in time, the cases establishing the doctrine of "perfection" illustrate the Court's historic indifference to these arguments advanced by the Colorado court in favor of Vorreiter's lien.

(4) *Lienor as Mortgagee, Pledgee, Purchaser and Judgment Creditor.* Although the terms "mortgagee" and "pledgee" are obviously inapplicable, various attempts have been made to fit state lienors into the categories of "purchaser" and "judgment creditor." Nevertheless, by Supreme Court definition, a purchaser is one who acquires title or possession, in the manner of vendor and vendee, for a valuable consideration,[22] while a judgment creditor is one who has received a judgment from a court of record.[23]

The *Vorreiter* case represents a state court's justifiable exasperation with the inequities inherent in the United States Supreme Court's unrealistic and severe interpretation of the federal tax lien law. To understand how the Supreme Court's interpretation has distorted the language of section 3670, it is necessary to consider another federal statute, section 3466 of the Revised Statutes.[24] Section 3466 grants the United States first priority for debts due it from an insolvent. The priority attaches when the debtor's property passes to a third person (other than a trustee in bankruptcy) for distribution to creditors. Section 3466 creates no lien. It merely bestows a priority to inusre that any debts due the United States will first be satisfied.[25]

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[19] Mr. Justice Jackson's concurring opinion in United States v. Security Trust & Savings Bank, 340 U. S. 47, 51 (1950), traced the history of the § 3670 lien and approved the contention that it created a secret general lien.

[20] Mackenzie v. United States, 109 F.2d 540 (9th Cir. 1940).

[21] United States v. Liverpool & L.&G. Ins. Co., 348 U. S. 215 (1955) (garnishment lien superseded by a subsequently arising tax lien that was recorded before judgment); United States v. Acri, 348 U. S. 211 (1955) (state lien contingent upon outcome of wrongful death action); United States v. Gilbert Associates, Inc., 345 U. S. 361 (1953) (prior city tax lein); United States v. Security Trust & Savings Bank, 340 U. S. 47 (1950); New York v. Maclay, 288 U. S. 290 (1933) (prior unliquidated state franchise taxes).

[22] United States v. Scovil, 348 U. S. 218, 221 (1955); and see United States v. Kings County Iron Works, 224 F.2d 232 (2d Cir. 1955).

[23] United States v. Gilbert Associates, Inc., 345 U. S. 361 (1953).

[24] Rev. Stat. § 3466 (1875), 31 U. S. C. § 191 (1952).

[25] Massachusetts v. United States, 333 U. S. 611 (1948). The lower federal courts have held that neither § 3466 nor § § 3670-2 apply to proceedings in bankruptcy, reasoning that to so apply them would upset the scheme of distribution set out in the Bankruptcy Act. See United States v. Sampsell, 153 F.2d 731 (9th Cir. 1946), and cases cited there. Re Taylorcraft Aviation Corp., 165 F.2d 808 (6th Cir. 1948), appears to fall within this classification, but was cited by the Colorado court to support its unjust enrichment argument in *Vorreiter*. 307 P.2d at 478.

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Early cases construing section 3466 apparently gave no credence to the theory that it created an absolute preference in favor of the United States to override antecedent liens.[26] However the twentieth century saw a growing tendency on the part of the Supreme Court to require that a state lien be "perfected" before it could compete with the federal priority for the funds of an insolvent.[27] The Court further implemented this growing doctrine by holding that the issue of perfection is, in the final analysis, a federal question.[28]

In *Illinois ex rel Gordon v. Campbell*[29] the Court reviewed and enumerated the elements which previous decisions had considered necessary to perfect a state lien. These were: (1) certainty of the identity of the lienor; (2) certainty as to the amount of the lien; (3) specific property attached by the lien, and (4) title to or possession of the affected property.[30] A lien deficient in any of these attributes when the federal priority arose was considered merely "a caveat of a more perfect lien to come."[31] Whether a sufficiently perfected state lien would in fact prevail over the federal priority is, as yet, merely conjectural. Because all the state liens yet to come before the Court have been found imperfct in some respect,[32] this important question has been reserved for later treatment.

The doctrinal armour of section 3466, with its almost unattainable standards, appears to have been transferred to the section 3670 tax lien in *United States v. Security Trust and Savings Bank.*[33] There a federal tax lien arose before a prior attaching creditor had pursued his lien to judgment. The Court held that since perfection of the creditor's lien was contingent on judgment, the federal lien must prevail.

However a ray of hope was extended to state lienors in *United States v. New Britain,*[34] where the Court found that certain city tax

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[26] Kennedy, note 4 *supra* at 907.
[27] Steps in this development were: Spokane County v. United States, 279 U. S. 80 (1929); New York v. Maclay, 288 U. S. 290 (1933); and United States v. Texas, 314 U. S. 480 (1941).
[28] United States v. Waddill, Holland & Flinn, Inc., 323 U. S. 353 (1945). But cf. Spokane County v. United States, 279 U. S. 80 (1929) (assumed the contrary).
[29] 329 U. S. 362, 375, 376 (1946).
[30] See United States v. Gilbert associates, Inc., 345 U. S. 361 (1953), where this last unique requirement of possession defeated a city's prior and otherwise specific liens for taxes.
[31] New York v. Maclay, 288 U. S. 290, 294 (1933).
[32] *E. g.*, United States v. Gilbert Associates, Inc., 345 U. S. 361 (1953).
[33] 340 U. S. 47 (1950).
[34] 347 U. S. 81 (1954).

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and water rent liens sufficiently met the standards of identity, certainty of amount and specificity of the property attached to defeat a subsequently arising federal tax lien under the common law rule of "first in time is first in right." In this case, as in all others involving unforeclosed liens, the city had neither title nor possession of the property to which its lien had attached. The Court's disregard of what had been a fatal defect in cases concerning the section 3466 priority[35] suggested a difference in application of the doctrine to the section 3670 lien.[36]

Unfortunately, the bright ray extended by *New Britain* seems to have been extinguished by *United States v. White Bear Brewing Co.*,[37] where a mechanics' lien was recorded and in the process of enforcement before the federal lien arose, but the federal lien was recorded before judgmnt foreclosing the mechanics' lien was entered. The Supreme Court, without opinion, reversed the Seventh Circuit which had held for the mechanics' lienor. Since the *White Bear Brewing Co.* lien appeared to meet the *New Britain* requirements, the logical inference is to mark *New Britain* as a departure from, and *White Bear Brewing Co.* as a return to, application of the section 3466 doctrine of perfection to the section 3670 lien.[38]

The unsoundness of this result was pointed out by Judge Finnegan in his opinion for the Seventh Circuit in *White Bear Brewing Co.*[39] He noted that since the United States is a government of delegated powers, it enjoys no sovereign prerogative of priority of payment. In the absence of federal common law, whatever priority the United States claims must exist by virtue of statute.[40] To Judge Finnegan, the absence of a priority provision in section 3670 indicated Congress' intention not to render the federal tax lien absolute. He might have further observed that, although section 3670 refers simply to "a lien" for unpaid taxes, only a tortured reading can construe "a lien" to mean what the United States Supreme Court has attributed to the section 3670 tax lien.

If this judicial legislation is what the Colorado court protested in the *Vorreiter* case, its exasperation is reasonable. If, however, the Colorado court protested the secret floating lien which unfairly deprives a creditor of his just debt, without notice or compensation, the question becomes one of due process, which should have been raised and decided.[41] Perhaps a more satisfactory solution would be Congressional action requiring fair notice of the federal tax lien, or, as has been suggested,[42] a system of priorities similar to that in the Bankruptcy Act.

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[35] *Compare New Britain with* United States v. Gilbert Associates, Inc., 345 U. S. 361 (1953). The facts appear indistinguishable, although the cases were distinguished.

[36] Kennedy, note 4 *supra* at 929-30.

[37] 227 F.2d 359 (7th Cir. 1955), *rev'd per curiam*, 350 U. S. 1010, *rehearing denied*, 351 U. S. 958 (1956).

[38] See Mr. Justice Douglas's dissent in United States v. White Bear Brewing Co., 350 U. S. 1010 (1956).

[39] United States v. White Bear Brewing Co., 227 F.2d 359 (7th Cir. 1955).

[40] Quoting Mr. Justice Story in United States v. State Bank, 31 U. S. (6 Pet.) 29, 35 (1832).

[41] Although due process was briefly mentioned in Chief Justice Moore's concurring opinion (307 P.2d at 479), a discussion of this point was conspicuously absent from the majority opinion.

[42] Kennedy, note 4 *supra* at 930.