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## The *McDermott* Tax Lien Case: And the First Shall Be Last

William H. Baker\*

In 1993, the United States Supreme Court decided an unusual case, *United States v. Bruce J. McDermott*,<sup>1</sup> which could affect the willingness of business people and creditors to contract and negotiate transactions with businesses with unimpressive balance sheets but good growth potential. *McDermott* involved the priority of a federal tax lien in relation to the claim of a state judgment creditor. The Supreme Court held, in a six-to-three decision, that even though the state court judgment was docketed prior to the filing of the tax lien, the federal tax lien should be given priority as to property acquired by the debtor after both liens were filed.<sup>2</sup>

The significant facts of *McDermott* are as follows. On July 6, 1987, the Zions First National Bank, N.A., docketed a state court judgment against Mr. and Mrs. McDermott in the clerk's office of Salt Lake County, Utah. On December 9, 1986, the United States assessed income tax liability against the McDermotts for the years 1977 through 1981. A lien for outstanding federal income taxes was filed by the Government on September 9, 1987, in the Salt Lake County Recorder's Office.<sup>3</sup>

The McDermotts acquired an interest in real property in Salt Lake County on September 23, 1987. To permit the sale of the property and to enable the lien claimants to satisfy their claims expeditiously, the parties agreed that the real property would be sold and the priorities of the lien claimants would be determined with respect to the cash proceeds of the sale as of the date that the McDermotts originally acquired the property—September 23, 1987.<sup>4</sup> The McDermotts then brought an interpleader action, seeking a judicial determination as to which of the adverse claimants had a superior claim to the proceeds.<sup>5</sup>

In an opinion by Justice Scalia, the Supreme Court held that even though the judgment obtained by the Zions First National Bank was docketed prior to the filing of the federal tax lien, the federal tax lien must be given priority as to any after-acquired property received by the debtor after the tax lien was filed.<sup>6</sup> The Court explained that the judgment creditor did not have a perfected lien until the debtor acquired an interest in property to which the judgment lien could attach. Although the federal tax lien did not become perfected until the same time, it, nevertheless, was entitled to priority under the language of Section 6323(a) of the Internal

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1. 113 S. Ct. 1526 (1993).

2. *Id.* at 1531.

3. *Id.* at 1527.

4. *Id.* at 1528.

5. *Id.*

6. *Id.* at 1531.

Revenue Code.<sup>7</sup> That section provides that a tax lien shall not be valid as against any judgment lien creditor (or any purchaser, holder of a security interest, or mechanic's lienor) until notice of the tax lien has been properly filed.<sup>8</sup>

The Court also stated that it based its holding on Section 6323(c) of the Code, which (under limited circumstances) grants priority, even as against a filed federal tax lien to security interests arising out of certain agreements. These agreements include written commercial transactions or financing agreements that are entered into before the federal tax lien is filed under which the taxpayer-debtor acquires commercial financing security (qualified property) before the forty-sixth day after the date on which the tax lien is filed. Section 6323(c) applies not only to *after-acquired property*, but also to loans secured by commercial financing security and to purchases of commercial financing security (other than inventory) made before the forty-sixth day after the tax lien filing.<sup>9</sup> The Court reasoned that in the absence

7. *Id.* at 1530.

8. Section 6323(a) of the Internal Revenue Code provides:

(a) Purchasers, holders of security interests, mechanic's lienors, and judgment lien creditors.—The lien imposed by § 6321 shall not be valid as against any purchaser, holder of a security interest, mechanic's lienor, or judgment lien creditor until notice thereof which meets the requirements of subsection (f) has been filed by the Secretary.

26 U.S.C. § 6323(a) (1988 & Supp. II 1990).

9. Section 6323(c) of the Internal Revenue Code provides:

(c) Protection for certain commercial transactions financing agreements, etc.—

(1) In general.—To the extent provided in this subsection, even though notice of a lien imposed by § 6321 has been filed, such lien shall not be valid with respect to a security interest which came into existence after tax lien filing but which—

(A) is in qualified property covered by the terms of a written agreement entered into before tax lien filing and constituting—

- (i) a commercial transactions financing agreement,
- (ii) a real property construction or improvement financing agreement, or
- (iii) an obligatory disbursement agreement, and

(B) is protected under local law against a judgment lien arising, as of the time of tax lien filing, out of an unsecured obligation.

(2) Commercial transactions financing agreement.—For purposes of this subsection—

(A) Definition.—The term "commercial transactions financing agreement" means an agreement (entered into by a person in the course of his trade or business)—

(i) to make loans to the taxpayer to be secured by commercial financing security acquired by the taxpayer in the ordinary course of his trade or business, or

(ii) to purchase commercial financing security (other than inventory) acquired by the taxpayer in the ordinary course of his trade or business;

but such an agreement shall be treated as coming within the term only to the extent that such loan or purchase is made before the 46th day after the date of tax lien filing or (if earlier) before the lender or purchaser had actual notice or knowledge of such tax lien filing.

(B) Limitation on qualified property.—The term "qualified property", when used with respect to a commercial transactions financing agreement, includes only commercial financing security acquired by the taxpayer before the 46th day after the date of tax lien filing.

26 U.S.C. § 6323(c)(1)-(2)(B) (1988).

of legislation giving priority to certain security interests, the federal tax lien would automatically receive priority. Ordinarily, for "first-in-time" priority purposes, the tax lien is effective from the date of filing, "regardless of when it attaches to the subject property."<sup>10</sup>

The judgment creditor argued that the first lien of record has priority over later filed liens unless a statute creating a particular lien clearly establishes that the statutory lien should be given priority. The Court stated that such a rule might be satisfactory in resolving priority conflicts between competing private lienholders whose liens ordinarily arise out of voluntary transactions.<sup>11</sup> In such cases, a potential creditor has the opportunity to inquire about any existing claims against the property of the potential debtor and can decide whether to extend credit on that basis. The Government, on the other hand, cannot decline to hold a taxpayer liable for taxes and, therefore, is not in the same position as a private lender. The Court concluded, therefore, that the "first to record" presumption is not appropriate under the tax lien statute.<sup>12</sup>

#### I. THE FEDERAL TAX LIEN STATUTE

Under Section 6321 of the Internal Revenue Code, if a person owes a tax and fails to pay it after demand, a lien for the amount owed, together with any interest and penalties imposed by law, arises in favor of the United States on all property and rights to property, real and personal, of the taxpayer.<sup>13</sup> The lien attaches from the date on which the tax assessment is made and continues in effect until the liability is paid or becomes unenforceable.<sup>14</sup> The lien is enforceable against the property of the taxpayer at any time, but must be properly filed to prevail against the claims of purchasers, holders of security interests, mechanic's lienors and judgment lien creditors.<sup>15</sup> Under Section 6323(b), even the filing of the lien will not grant the Government priority as to

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10. 113 S. Ct. at 1530.

11. *Id.* at 1530-31.

12. *Id.* at 1530.

13. Section 6321 of the Internal Revenue Code provides:

If any person liable to pay any tax neglects or refuses to pay the same after demand, the amount (including any interest, additional amount, addition to tax, or assessable penalty, together with any costs that may accrue in addition thereto) 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.

26 U.S.C. § 6321 (1988).

14. Section 6322 of the Internal Revenue Code provides:

Unless another date is specifically fixed by law, the lien imposed by § 6321 shall arise at the time the assessment is made and shall continue until the liability for the amount so assessed (or a judgment against the taxpayer arising out of such liability) is satisfied or becomes unenforceable by reason of lapse of time.

26 U.S.C. § 6322 (1988).

15. *See supra* note 8.

subsequent (superpriority) creditors who are specifically designated in the statute.<sup>16</sup>

The tax lien statute has evolved over a long number of years. The statute was first enacted in 1866.<sup>17</sup> At that time, even though the lien was not filed, it was given priority over *bona fide* purchasers for value.<sup>18</sup> Through the years, changes in the statute have been made to protect various claimants from unfiled tax liens.<sup>19</sup> In 1913, purchasers, mortgagees and judgment creditors received such protection.<sup>20</sup> In 1939, Congress added pledgees to the list of those creditors protected against unfiled or improperly filed federal tax liens.<sup>21</sup> Under the Federal Tax Lien Act of 1966 (hereinafter referred to as the "1966 Act" or "the Act"),<sup>22</sup> holders of security interests were given priority over unfiled federal tax liens. The Act recognized mortgagees and pledgees as those having protected security interests.<sup>23</sup> Under a previous version of Section 6323(a), the term "judgment creditor" had been interpreted as requiring that a judgment creditor have a choate lien to prime an unfiled tax lien. The 1966 Act codified this interpretation by referring to such a creditor as a "judgment lien creditor."<sup>24</sup> In addition, the 1966 Act redefined the term "purchaser"<sup>25</sup> and included mechanic's lienors within the protected class of creditors.<sup>26</sup>

16. Section 6323(b) of the Internal Revenue Code provides:

Protection for certain interests even though notice filed.—Even though notice of a lien imposed by § 6321 has been filed, such lien shall not be valid—

- (1) Securities. . . .
- (2) Motor vehicles. . . .
- (3) Personal property purchased at retail. . . .
- (4) Personal property purchased in casual sale. . . .
- (5) Personal property subject to possessory lien. . . .
- (6) Real property tax and special assessment liens. . . .
- (7) Residential property subject to a mechanic's lien for certain repairs and improvements. . . .
- (8) Attorneys' liens. . . .
- (9) Certain insurance contracts. . . .
- (10) Passbook loans. . . .

26 U.S.C. § 6323(b) (1988).

17. Act of July 13, 1866, 14 Stat. 107. See also Act of March 3, 1865, 13 Stat. 469.

18. *United States v. Snyder*, 149 U.S. 210, 13 S. Ct. 846 (1893).

19. See William T. Plumb, Jr., *Federal Liens and Priorities—Agenda for the Next Decade*, 77 Yale L.J. 228, 230-31 (1967).

20. Act of March 4, 1913, Pub. L. No. 451, 37 Stat. 1016.

21. Revenue Act of 1939, Pub. L. No. 155, 53 Stat. 882.

22. Federal Tax Lien Act of 1966, Pub. L. No. 89-719, 80 Stat. 1125.

23. Federal Tax Lien Act of 1966 § 101(a), codified as amended at 26 U.S.C. § 6323 (1988).

24. *Id.*

25. See Federal Tax Lien Act of 1966 § 101(a). Section 101(a) amended § 6323(a) of the Internal Revenue Code and added § 6323(h)(6) to the Internal Revenue Code. 26 U.S.C. § 6323(a), (h)(6) (1988).

26. See Federal Tax Lien Act of 1966 § 101(a). Section 101(a) added § 6323(h)(2) to the Internal Revenue Code. 26 U.S.C. § 6323(h)(2) (1988).

The 1966 Act also created a new priority for certain classes of security interests.<sup>27</sup> As previously indicated, the *McDermott* court based its holding, in part, on the conclusion that Section 6323(c)(1) would not have been necessary if the creditors referred to in the statute had been able to secure priority over federal tax liens with respect to after-acquired property.<sup>28</sup> Under Section 6323(c) of the Code, after-acquired security property acquired by the debtor more than forty-five days after the date of tax lien filing will not be treated as "qualified property" and will not, therefore, entitle the creditor to priority over a filed tax lien.<sup>29</sup>

A federal tax lien does attach to the after-acquired property of a taxpayer.<sup>30</sup> The question presented in *McDermott*, however, focuses on how priority should be determined when a judgment creditor is first to docket his judgment, the United States subsequently files its tax lien, and later still, the debtor acquires the property in question.

## II. THE PERFECTION OF LIENS

The nature of a property interest is a question of state law.<sup>31</sup> Federal law, however, determines questions of priority.<sup>32</sup>

In *United States v. City of New Britain*,<sup>33</sup> the Supreme Court indicated that, in the absence of legislation to the contrary, the priority of statutory liens is to be determined by the common-law principle, "the first in time is the first in right."<sup>34</sup> The Court stated, "[w]e think that Congress had this cardinal rule in mind when it enacted § 3670 [now Section 6321], a schedule of priority not being set forth therein. Thus, the *priority* of each statutory lien contested here *must depend on the time it attached to the property in question and became choate.*"<sup>35</sup>

A perfected lien attaches to the property in question and thereby becomes choate. In *New Britain*, the Supreme Court indicated "liens may also be perfected

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27. Section 101(a) of the Federal Tax Lien Act of 1966 added § 6323(c) to the Internal Revenue Code. 26 U.S.C. § 6323(c) (1988). See *supra* note 9.

28. See *United States v. McDermott*, 113 S. Ct. 1526, 1530 (1993). See also 26 U.S.C. § 6323(c)(1) and (c)(2)(A) (1988), *supra* note 9.

29. See *supra* note 9.

30. See *Glass City Bank v. U.S.*, 326 U.S. 265, 66 S. Ct. 108 (1945) (holding that a debt owed to the taxpayer, which came into existence after the federal tax lien became effective, was subject to the tax lien because the lien attaches to property owned by the taxpayer at any time during the life of the lien).

31. *U.S. v. Durham Lumber Co.*, 363 U.S. 522, 80 S. Ct. 1282 (1960).

32. *U.S. v. Waddill, Holland & Flinn, Inc.*, 323 U.S. 353, 65 S. Ct. 304 (1945); *U.S. v. Pioneer Am. Ins. Co.*, 374 U.S. 84, 83 S. Ct. 1651 (1963); *Aquilino v. U.S.*, 363 U.S. 509, 80 S. Ct. 1277 (1960).

33. 347 U.S. 81, 74 S. Ct. 367 (1954).

34. *Id.* at 85, 74 S. Ct. at 370 (citing *Rankin v. Scott*, 12 Wheat. 177, 179 (1827)).

35. *Id.* at 86, 74 S. Ct. at 370 (emphasis added).

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.”<sup>36</sup> Although the Government took the position in *U.S. v. Vermont*<sup>37</sup> that for a state lien to be choate, it must attach to specifically identified property and cannot attach to “all of the taxpayer’s property,”<sup>38</sup> the Supreme Court ruled that general liens may be treated as perfected, just like liens attaching to specific property.<sup>39</sup>

Relying on *New Britain*, the *McDermott* Court concluded that the judgment lien of the bank was not perfected until the debtor acquired an interest in the real estate in question. *New Britain* held that one of the three tests for perfection of a lien is that the property subject to the lien must be established.<sup>40</sup> This test was not satisfied until the debtor acquired an interest in the property after the federal tax lien had been filed. The judgment creditor took the position that its lien attached to all of the taxpayer’s real property, then owned or thereafter acquired, from the moment the judgment was docketed on July 6, 1987. This argument was based on a Utah statute,<sup>41</sup> the view that the judgment creditor had done everything possible to perfect its lien, and the contention that nothing further was required to complete its claim as against after-acquired property. Justice Thomas, dissenting, agreed that *New Britain* supported the judgment creditor’s position.<sup>42</sup> In *New Britain*, however, the Court defined a perfected and choate lien as one in which the identity of the lienor, the property subject to the lien, and the amount of the lien can be identified. The *McDermott* Court’s determination that the judgment creditor could not have a perfected a choate lien until the after-acquired property came into existence reflects the principles established by the *New Britain* case.<sup>43</sup>

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36. *Id.* at 84, 74 S. Ct. at 369. It is noted that the Treasury Regulations, 26 CFR § 301.6323(h)-1(g), use this same language in describing when a judgment lien will be treated as perfected.

37. 377 U.S. 351, 84 S. Ct. 1267 (1964).

38. *Id.* at 355, 84 S. Ct. at 1269.

39. *Id.* at 357-58, 84 S. Ct. at 1271.

40. *United States v. McDermott*, 113 S. Ct. 1526, 1528-30 (1993).

41. *See* Utah Code Ann. § 78-22-1 (1953) which provided that when a judgment is docketed, it becomes a lien on all real property of the debtor and on all real property thereafter acquired in the county where the judgment is docketed.

42. 113 S. Ct. at 1533 (Thomas, J., dissenting). The dissent took the position that the bank’s judgment lien was perfected when it was docketed because nothing further remained to be done by the bank. Since the docketing of the lien occurred prior to the filing of the federal tax lien, the judgment lien would be granted priority. The dissent argued that if specific attachment of the state lien in *Vermont* was not required for the lien to be considered sufficiently choate, then the specific acquisition (of property by the debtor) is not required in order for the judgment creditor to have a perfected lien. It is difficult to see, however, how a lien can become perfected on property that is not yet in existence or in which the debtor has no interest. As the majority opinion points out, it is one thing to say a creditor has acquired a perfected lien on property of a debtor by virtue of a general lien which does not specifically identify the particular property; it is another thing to say that a perfected lien can attach to property at a time when the debtor has no interest in it. 113 S. Ct. at 1529 n.3.

43. 347 U.S. 81, 84, 74 S. Ct. 367, 369 (1954).

Neither the judgment creditor's lien nor the federal tax lien was perfected until the debtor acquired property to which the liens could attach. Accordingly, when the debtor acquired an interest in the real property in question, both liens became perfected at the same instant. Once the Court determined that both liens were perfected at the same instant, the question then became how priority should be determined in the case of simultaneous attachment.

### III. DETERMINING PRIORITIES

By holding that the federal tax lien was not perfected until the taxpayer acquired an interest in the property in question but that the priority question should be decided with reference to the date the federal tax lien was filed, the Court, in effect, used a relation-back doctrine to give the Government priority. The Court relied on the language of Section 6323(a) as supporting the proposition that "the filing of notice renders the federal tax lien extant for 'first in time' priority purposes regardless of whether it has yet attached to identifiable property."<sup>44</sup> This position is inconsistent with the Court's holding that the federal tax lien was not perfected until the taxpayer acquired an interest in the after-acquired property. It also is inconsistent with *New Britain*<sup>45</sup> in which the Court stated "the priority of each statutory lien contested here must depend on the time it attached to the property in question and became choate."<sup>46</sup>

If Section 6323(a) granted priority to the tax lien, then why was it necessary for the Court to find that the tax lien was not perfected until the property came into existence? As indicated above, *New Britain* held that the priority of liens depends on the time they attach to the property and become choate. In addition, the relation-back doctrine was repudiated in *U.S. v. Security Trust & Savings Bank*,<sup>47</sup> in connection with a claim by a creditor who initially instituted an attachment proceeding and subsequently secured a judgment against the debtor.

The Court's reliance on the language of Section 6323(a), which gives the Government priority in a case where the competing liens attached to the after-acquired property at the same instant, is unconvincing. If the date of perfection is meaningless for the purpose of determining priorities, then the judgment creditor should prevail on the language of Section 6323(a) alone, since under the "first-in-time" concept, it docketed its judgment before the Government filed its tax lien.<sup>48</sup>

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44. 113 S. Ct. at 1530 (emphasis added).

45. 347 U.S. 81, 74 S. Ct. 367 (1954).

46. *Id.* at 86, 74 S. Ct. at 370 (emphasis added).

47. 340 U.S. 47, 71 S. Ct. 111 (1950).

48. The Court's position on this point, *see supra* note 11, which differentiates the Government from other creditors on the theory that the Government cannot decline to hold a taxpayer liable for taxes, whereas ordinary creditors can decide whether or not to advance funds to a debtor after the creditor knows of a prior lien, is difficult to follow. The priority of federal tax liens as against other claims ordinarily is determined with reference to the timeliness of the claims and not with reference to alternative options which may or may not be available to the creditors. *See supra* note 14 for a discussion of the perfection of liens.

Under *New Britain*, however, the date of perfection is the key date for priority purposes.

In *McDermott*, both liens attached at the same time. Section 6323 says nothing at all about priority when there is simultaneous attachment.<sup>49</sup> In addition, it does not appear that Congress contemplated after-acquired property at the time the statute was enacted. The committee report of the United States House of Representatives, relating to the 1913 amendment of the statute,<sup>50</sup> provided that "the lien is so comprehensive that it covers all the property and rights to property of the delinquent."<sup>51</sup> In addition, the current version of Section 6323(a) refers to the validity of the federal tax lien as against the four types of claimants set forth in the section<sup>52</sup> and provides, "[t]he lien imposed by § 6321 applies to 'all property and rights to property, whether real or personal, belonging to such person.'" Together, the House Report and the statute refer only to property in which a taxpayer has an interest. No reference whatsoever is made to after-acquired property.

Accordingly, the Court's reliance on Section 6323(a) in granting priority to the federal tax lien in an after-acquired property case such as this is not supported by the language of the statute<sup>53</sup> and is inconsistent with *New Britain*.

#### IV. SECTION 6323(C)(1)

The Court relied on Section 6323(c)(1) as support for its holding in *McDermott*. Section 6323(c)(1) grants special priority to certain types of state security interests, even as against recorded federal tax liens. The Court reasoned that such special protection would be unnecessary if the federal tax lien were not otherwise afforded priority under the Code.

Section 6323(c) of the Internal Revenue Code was enacted as part of the 1966 Federal Tax Lien Act. The Senate Finance Committee Report accompanying this section stated in part,

Under present law, a filed tax lien has priority over the rights of the lender or purchaser if the funds are not advanced, or the security purchased, until after the tax lien filing. In addition, it has priority

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49. See *Southern Rock, Inc. v. B & B Auto Supply*, 711 F.2d 683, 688 (5th Cir. 1983), where the Court stated, "[w]e are left with a simultaneous filing and must decide who wins when the race to the recording office ends in a tie. The statute does not say." After referring to the wording of the statute, the Court continued, "The section does not indicate whether the tax lien prevails if it is filed at the same time as the 'holder of a security interest' comes into existence." *Id.*

50. Act of March 4, 1913, Pub. L. No. 451, 37 Stat. 1016.

51. H.R. Rep. No. 1018, 62d Cong., 2d Sess. 2 (1911-1912).

52. See *supra* note 8.

53. The dissenting opinion in *McDermott* states that the word "filed" used in § 6323(a) "provides no textual basis for concluding that a tie goes to the Government, and simply declaring that it does, does not make it so." See *United States v. McDermott*, 113 S. Ct. 1526, 1534 n.4 (1993) (citations omitted).

under present law if the initial assets are replaced with assets acquired after the tax lien filing. As a result, under present law for a lender or purchaser to be sure that no tax lien has recently been filed, he must search the records each time before making an additional advance or purchase. The provision added by the bill is designed to keep this obligation within practical bounds by giving the interests arising under the agreements providing for these loans or purchases priority over a filed tax lien if the loans or purchases are made not later than 45 days after the tax lien filing and before the lender or purchaser has actual notice of the filing.<sup>54</sup>

It appears that Section 6323(c)(1) primarily was designed to alleviate a problem being faced by commercial lenders and purchasers of commercial financing security who consummate transactions with the debtor pursuant to a written agreement entered into prior to the filing of the tax lien but without knowledge that the tax lien has been filed. The primary thrust of that provision is to permit these loans and purchases to be made within a particular time frame so that the lenders and purchasers do not have to search the records to make certain that a tax lien has not been filed recently.

But in *McDermott*, all action that could be taken by the judgment creditor was taken prior to the recording of the federal tax lien. There was no ongoing commercial relationship between debtor and creditor. The opinion of the Court cited no cases to support its proposition that without enactment of Section 6323(c), the federal tax lien would be given priority over judgment creditors with respect to after-acquired property.<sup>55</sup> The Senate Finance Committee Report also does not refer to a need to enact Section 6323(c) in order to alleviate a problem existing as to judgment creditors who have pursued their claims to finality prior to the filing of a federal tax lien.<sup>56</sup>

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54. S. Rep. No. 1708, 89th Cong., 2d Sess. 8 (1966).

55. The Court stated that the federal tax lien was entitled to priority regardless of whether it had attached to any identifiable property. The Court reasoned:

[t]hat result is also indicated by the provision two subsections later, which accords priority, even against filed federal tax liens, to security interests arising out of certain agreements, including "commercial transactions financing agreement[s]," entered into before filing of the tax lien. 26 U.S.C. § 6323(c)(1). . . . According special priority to certain state security interests in these circumstances obviously presumes that otherwise the federal tax lien would prevail . . . .

See 113 S. Ct. at 1530.

56. Under present law, a filed tax lien has priority over the rights of the lender or purchaser if the funds are not advanced, or the security purchased, until after the tax lien filing. In addition, it has priority under present law if the initial assets are replaced with assets acquired after the tax lien filing.

S. Rep. No. 1708, 89th Cong., 2d Sess. 8 (1966); see also Michael D. McCullough, Note, *When First in Time Is Not First in Right: The Supreme Court Frustrates Judgment Creditors in United States v. McDermott*, 25 Loy. U. Chi. L.J. 405 (1994). See also *infra* note 65.

## V. CASES SUPPORTING PRIORITY FOR TAX LIENS AS TO AFTER-ACQUIRED PROPERTY

Cases both before and after the 1966 Act have given federal tax liens priority over other liens with respect to property acquired by the debtor after the tax lien was filed.<sup>57</sup>

Some of these decisions, however, do not appear to be based on convincing authority. A case often cited as authority is *United States v. Graham*.<sup>58</sup> In *Graham*, a federal tax lien was filed before the taxpayer leased property to the State of California. Although it is clear the state assessed taxes against the taxpayer after the federal tax lien was filed, it is uncertain whether the State tax lien existed prior to, or after, the accrual of rent due from the state. When the United States sought to foreclose its lien on the rental payments due the taxpayer, the state contended that no property of the taxpayer existed against which the federal tax lien could be foreclosed and, even if such property did exist, the State's right of set-off primed the federal tax lien.

The court ruled in favor of the United States, holding that the right to rental income was a property interest subject to foreclosure, that the federal taxes were assessed long before the leases were executed and any rent became due, and that "the rights of the taxpayer under the lease were born with the tax lien impressed thereon."<sup>59</sup> The federal tax lien, however, could not attach to property not yet in existence, i.e. rental payments which would become due under a lease which had not yet been executed. The federal tax lien could only attach to rental payments due under an existing lease. Apparently, the court applied the "first-in-time" rule with no regard to when the property was acquired by the debtor. The court stated, "[i]f the state had a right of set-off against the taxpayer prior to the United States' asserted lien and priority, the Collector would be bound to recognize the right of the state to set-off."<sup>60</sup> Believing that the lien of the United States was first in time, the court granted priority to the federal tax lien.

In dicta, the court indicated that even assuming that there had been simultaneous attachment of the tax liens and the right of set-off, "[n]o citation of authority is needed to establish that the federal tax lien is superior to any simultaneously attaching interest of the State of California."<sup>61</sup>

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57. The pre-1966 law was referred to in *Shawnee State Bank v. United States*, 735 F.2d 308 (8th Cir. 1984). Cases which considered this priority question include *United States v. Graham*, 96 F. Supp. 318 (S.D. Cal. 1951), *aff'd mem.*, 195 F.2d 530 (9th Cir.), *cert. denied*, 344 U.S. 831 (1952); *Stockholders Pub. Co. v. Smith*, 56-1 U.S. Tax Cas. par. 9420 (S.D. Calif. 1956); *Randall v. Colby*, 190 F. Supp. 319, 341 (N.D. Iowa 1961); *In re Nap J. Hudon & Son, Inc.* 65-2 U.S.T.C. 9517 (D. Mass. 1964); *Dean Constr. Co. v. Simonetta Concrete Constr. Co.*, 37 F.R.D. 242 (S.D.N.Y. 1965). See also *Plumb*, *supra* note 19.

58. 96 F. Supp. 318.

59. *Id.* at 321.

60. *Id.*

61. *Id.* (emphasis added). It would have been helpful if the Court had apprised us of the authority on which it was relying.

Subsequent cases cited *Graham* as a persuasive authority on the question of simultaneous attachment of liens to after-acquired property. For example, *Bank of Nevada v. United States*<sup>62</sup> involved a situation where a federal tax lien attached to a taxpayer's bank account at a time when a competing creditor, a bank, had only an inchoate claim against the taxpayer. The court rejected the bank's set-off claim, citing *Graham* and stating simply, "We adhere to the teaching in *Graham*."<sup>63</sup>

In *In re Nap J. Hudon & Son, Inc.*,<sup>64</sup> the contest was between the federal tax lien and a bank-assignee of accounts receivable from the taxpayer-debtor. The taxpayer was owed money on two contracts with Quincy Shipbuilding & Repair Co. Before the federal taxes were assessed and liens arose, the identity of the lienholder and the amount of the lien were known, but the property subject to the lien was not sufficiently specific and definite until the taxpayer submitted invoices to Quincy for work done under the contracts. When the property came into existence, the creditor's lien and the federal tax lien attached simultaneously. Despite the fact that the assignee's lien attached to the account receivable when the account came into existence, the court awarded priority to the federal tax lien because it was filed prior to the date the account came into existence. The court, however, never discussed the question of simultaneous attachment.

In footnote seven of *McDermott*, the Court stated that Section 6323(a) does not distinguish between security interests and judgment creditors, and because Section 6323(c) assumes "that all perfected security interests are defeated by the federal tax lien," the same assumption should apply to judgment liens.<sup>65</sup>

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62. 251 F.2d 820 (9th Cir. 1957).

63. *Id.* at 825.

64. 65-2 U.S.T.C. 9517 (D. Mass. 1964).

65. Although it is true that Section 6323(a) of the Internal Revenue Code refers to a purchaser, holder of a security interest, mechanic's lienor or judgment lien creditor in an equal way, there still is a significant difference between what is required in the case of each in order to achieve full-fledged status under that section. For example, a judgment creditor ordinarily has a lien on real property once he has docketed his judgment properly under state law. *McAllen State Bank v. Saenz*, 561 F. Supp. 636 (S.D. Texas 1982). In New York, as in many states, state law requires judgment creditors to execute on their judgment in order to acquire a lien against personal property. See *Dean Constr. Co. v. Simonetta Concrete Constr. Corp.*, 37 F.R.D. 242 (S.D.N.Y. 1965). Where the funds of a debtor are in the hands of a third person, a judgment creditor would have to issue a third party subpoena and restraining order in supplementary proceedings to acquire a lien. *Id.* See also *Safemasters Co. v. D'Annunzio & Circosta*, 94-2 T.C. 50,410 (D. Md. 1994), where a creditor was held not to have a perfected lien until a writ of garnishment was served on a third party who was holding funds belonging to the debtor. A purchaser, a holder of a security interest and a mechanic's lienor will have to take different steps, appropriate to their status, to achieve complete recognition (choateness) under Section 6323(a).

The primary purpose of Section 6323(c) was to protect certain creditors and purchasers who advanced funds to businesses. See *supra* note 54. Section 6323(c) does not relate to the question of priority with respect to judgment lien creditors. It is related, however, to the fact pattern in *McDermott* because it refers to the priority that is to be given to certain types of creditors under limited circumstances with respect to the after-acquired property of the debtor. See also *supra* part IV.

Accordingly, the Court disagreed with the dissent's view that the common law rule of parity should be adopted and that the judgment creditor should be given an equal interest in the property (if the creditor is not given outright priority on the theory that its lien, in fact, was perfected prior to the federal tax lien).

Other cases involving an assignee's claim and a federal tax lien have taken the position that in the case of simultaneous attachment of liens, the federal tax lien wins. These cases have cited *Graham* and its progeny as authority for this proposition.<sup>66</sup>

The idea of allowing the concept of parity to control where a creditor's claim lacked "choateness" was rejected in *Texas Oil & Gas Corporation v. United States*.<sup>67</sup> This opinion presented a detailed history of the competition between federal tax liens and the liens acquired by creditors under state law.<sup>68</sup>

#### VI. CASES DENYING PRIORITY TO FEDERAL TAX LIENS AS TO AFTER-ACQUIRED PROPERTY

Recent cases involving the simultaneous attachment issue have treated non-federal liens more favorably. Like *McDermott, McAllen State Bank v. Saenz*<sup>69</sup> involved competing federal tax liens and judgment liens which predated the acquisition of property by the debtor. Citing *Graham v. United States* as authority, the United States contended that the competing liens had attached to the after-acquired property simultaneously and that the federal tax lien should, therefore, be granted priority. The court criticized *Graham*, stating that it did not stand for the proposition that federal liens prime other simultaneously attaching liens. In *Graham*, the court explained that the federal tax lien was in effect long before the state's right of set-off existed. The federal tax lien was thus given priority. To demonstrate that *Graham* relied on the first-in-time doctrine, the court referred to the language used by the court therein: "If the state had a right of set-off against the taxpayer prior to the United States' asserted lien and priority, the Collector would be bound to recognize the right of the state to set-off."<sup>70</sup>

The court in *McAllen State Bank* applied a first-in-time, first-in-right rule, based on the filing date of the liens in question, stating "[t]here appears to be no legal or policy reason that would mandate a deviation from the first in time, first

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66. See *MDC Leasing Corp. v. New York Property Ins. Underwriting Ass'n*, 450 F. Supp. 179 (S.D.N.Y. 1978), *aff'd without published opinion*, 603 F.2d 213 (2d Cir. 1979); *United States v. Meyer*, 346 F. Supp. 554 (S.D.N.Y. 1972); *V.J. Processors, Inc. v. Fireman's Fund Ins. Cos.*, 679 F. Supp. 399 (D. Vt. 1987). See also *Gaeta v. United States*, 82-2 U.S.T.C. 9525 (W.D.N.Y. 1982).

67. 466 F.2d 1040 (5th Cir. 1972).

68. See also *Rice Inv. Co. v. United States*, 625 F.2d 565 (5th Cir. 1980); *Gaeta*, 82-2 U.S.T.C. at 9525.

69. 561 F. Supp. 636 (S.D. Tex. 1982).

70. *Id.* at 639.

in right rule. The rule encourages diligent filing of liens whether or not after-acquired property is involved.<sup>71</sup>

In 1983, in *Southern Rock, Inc. v. B & B Auto Supply*,<sup>72</sup> a federal tax lien and a perfected security interest became effective on the same day. The court observed that Section 6323(a) says nothing about which party wins in a simultaneous attachment case. Acknowledging that *MDC Leasing*,<sup>73</sup> which cited *Graham* as authority, had granted priority to the federal tax lien in a simultaneous filing case, the court stated that the *MDC* decision was based on a pre-Federal Tax Lien Act interpretation of the Code. *MDC Leasing's* language indicated reliance on the doctrine that to be entitled to priority or to fall within one of the exceptions set forth in the Code, a competing lien had to be choate prior to attachment of the federal tax lien. The Federal Tax Lien Act of 1966 was designed to conform the tax lien provisions to the Uniform Commercial Code and to provide some limited relief from the harshness of the choateness rule. In the court's view, Section 6323 had supplanted the choateness doctrine:

In our view, another aspect of choateness that no longer floats, although concededly not specifically addressed by § 6323, is the notion that a tie goes to the government. To the extent that the purpose of the Federal Tax Lien Act was to conform tax liens to Article 9 security interests, the way to achieve this goal is to treat the government like any other creditor. Giving the government's filed tax lien priority over a simultaneously recorded security interest would defeat this goal. We do not believe that is what Congress intended.<sup>74</sup>

The court, therefore, held that the two liens should share the fund in question in proportion to their claims.<sup>75</sup>

## VII. CONCLUSION

The problem presented by *McDermott* cannot be resolved easily. The majority opinion noted the lack of clarity in the statute when it concluded: "Thus, while we would hardly proclaim the statutory meaning we have discerned in this opinion to be 'clear,' it is evident enough for the purpose at hand."<sup>76</sup> The dissent also acknowledged the confusion present in the law on this point by

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71. *Id.* at 639, 640.

72. 711 F.2d 683 (5th Cir. 1983).

73. *Id.* at 689.

74. *Id.* at 689.

75. *See also* *United States v. Fleming*, 474 F. Supp. 904 (S.D.N.Y. 1979), which held that the competing liens should share the fund on a pro rata basis. In that case, the court reasoned that since the *City of New Britain* case applied the common law rule of "first in time is the first in right" to property owned by the debtor at the time the competing liens arose, in the case of after-acquired property, it is appropriate to apply the common law rule which provides for pro rata distribution.

76. *United States v. McDermott*, 113 S. Ct. 1526, 1531 (1993).

stating, "our precedents do not provide the clearest answer to the question of after-acquired property."<sup>77</sup> In *McDermott*, it is clear that both liens were perfected and attached to the real property at the same instant—when the taxpayer acquired an interest in the property. The question then arises as to how priority should be determined in a simultaneous attachment case. Section 6323(a) says nothing about after-acquired property and does not purport to provide for priority in a "tie" situation. Section 6323(c) does not relate to judgment lien creditors but was intended to protect certain security interests against filed federal tax liens in limited situations.

Some cases have given priority to the federal tax lien in simultaneous attachment cases. Other recent cases have held that the competing lien should either be given priority or that both should share the fund on a proportionate basis.

Because *McDermott* involved after-acquired property, it represents an unusual example of a simultaneous attachment case. In a case where two liens attach at the same time to *property owned by the debtor*, the position of the non-federal lien might not seem as strong as in a case like *McDermott*, where the judgment creditor pursued its claim to finality before the federal tax lien was filed and would have been granted complete priority if the taxpayer had owned the property at the time the liens attached. The only reason that simultaneous attachment resulted in *McDermott* was because of the presence of after-acquired property, a factor which had nothing to do with the diligence of the claimants.

Under *McDermott*, even if the judgment creditor's judgment had been docketed many years before the Government assessed the debtor's tax liability and filed its tax lien, the federal tax lien would still be awarded priority as to the after-acquired property. Congress did not have such a result in mind when it enacted Sections 6321-6323 of the Internal Revenue Code. The goal of Congress was to reward the claimant who first pursued his claim to finality.<sup>78</sup> *New Britain*, which announced "the first in time is the first in right" rule, followed this interpretation of the statute. The language used by the Court in *New Britain*, however, does not suggest that the Court intended to establish one rule for cases in which the debtor owned property when the liens attached and another rule for cases in which the debtor acquired property after the liens attached. Rather, the Court was emphasizing those actions a claimant must take to perfect his claim. One such action, according to the Court, was that the property subject to the lien be identified. Only then may the lien be considered choate and perfected. In an after-acquired property case, however, this requirement cannot be satisfied until the taxpayer acquires an interest in the property.

The dissent concluded that the judgment creditor secured a perfected lien when the judgment was docketed. This conclusion does not, however, satisfy the requirements of the *New Britain* case. Moreover, it is difficult to see how the

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77. *Id.* at 1534.

78. See *McAllen State Bank v. Saenz*, 561 F. Supp. 636, 640 (S.D. Tx. 1982).

judgment creditor could be awarded priority on that theory under the law as it now stands. The dissent's position that the claimants should share the fund available, based on the common law rule of parity, is, nevertheless, a logical and fair way of disposing of a case of this kind under existing statutory law and *New Britain*. Such a conclusion is also supported by the Fifth Circuit's decision in *Southern Rock, Inc. v. U.S.*<sup>79</sup>

Given the uncertainty of the law, Congress should consider amending the statute to reward diligent action by claimants in pursuing their claims to finality, regardless of whether after-acquired property is involved. This change would provide an element of certainty and confidence to creditors who extend credit to debtors. Such creditors could then rely on the fact that, even if the debtor's assets may not provide adequate protection to cover a contemplated transaction, a judgment secured by the creditor would place the creditor in a good position with respect to any assets subsequently acquired by the debtor. Later filed federal tax liens would not affect any recovery which the creditor would otherwise be in a position to receive. Congress should also consider a provision for a pro rata sharing of a fund in those cases where the federal tax lien and the lien of an adverse claimant are established at the same time with respect to existing property of the debtor.

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79. 711 F.2d 683 (5th Cir. 1983).

