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Security Transactions—Priority—Federal Tax Liens and Future Advance Mortgages

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tim the *Miller* rule, and thus reaffirmed its past position. Since one can not be certain what *Young* may stand for, the following conclusions should be drawn:

1. Because the court has not seen fit to explicitly overrule *Miller v. Scarbrough*,[44] to file valid mortgages on shifting stocks, the attorney must continue to follow the *Miller* requirements and include the requisite provisions within the mortgage itself.

2. The entire mortgage will be found invalid if the mortgagee fails in his duty to see that the mortgagor complies with the mortgage terms, whereas, in other types of financing, *e.g.*, accounts receivable, mere loss of collateral results.

3. It is still uncertain whether anything except business expenses may be taken from the proceeds, although it appears that the court's concept of what constitutes a business expense has broadened.[45]

4. Although the court indicated that the accounting might be something less than a strict accounting, *e.g.*, a business accounting geared to each situation, it would be wise, to prevent future litigation on the question of fraud, to continue the practice of strict accounting as in the past.

It should be hoped that the future will hold more flexibility for inventory financing. Recording statutes, credit ratings, and other procedures are available to protect creditors. The court should continue to promote inventory financing by discarding needless rules which hamper financing[46] and should resolve the confusion caused by the contradictory positions stated in the *Young* case. However, until it does, a wait-and-see attitude will be necessary.

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Priority—Federal Tax Liens and Future Advance Mortgages. In *American Surety Co. v. Sundberg*[1] the Washington Supreme Court

[44] 108 Wash. 646, 185 Pac. 625 (1919).

[45] In *Young*, for example, the court allowed the deduction of Young's personal living expenses, which in this situation was necessary to the business because Young, who devoted his entire time to the business, was unsalaried. U.S. Rubber's argument that, under Income Tax definitions, personal expenses could not be business expenses did not persuade the court. The court realized that in a sole proprietorship business—where salaries are not usually received—it is to the creditor's benefit that the owner be able to devote all his time to making profits rather than using part of it to earn income to meet his personal expenses.

[46] "... the result is that one who extends credit to a merchandiser and attempts to protect himself by a mortgage on a shifting stock of goods as security, even though he complies with the recording statutes, becomes an insurer of the mortgagor's performance of the contract. Such a liability would render the security valueless." United States Rubber Co. v. Young, 57 Wn.2d 686, 689-90, 359 P.2d 315, 317 (1961).

[1] 158 Wash. Dec. 335, 363 P.2d 99 (1961).

made a startling encroachment upon the sanctity of a secured mortgage. Using the United States Supreme Court's test of "choateness,"[2] the court held that the lien of a mortgage securing future advances is subordinate to federal tax liens filed subsequent to the filing of the mortgage, but prior to advances for which the lien was claimed.

In February, 1955, Oscar Sundberg & Sons, a partnership, entered into a contract with Boeing Airplane Company to do certain painting. American Surety Company entered into a performance bond in favor of Boeing, which required the surety to complete or cause the contract to be completed if the Sundbergs were unable to perform.

During the months of July and August, 1955, six advances totaling over $35,000 were made by the surety. It was agreed that these advances would be secured by mortgages on real property owned by the individual partners. Three mortgages were recorded on property in King County on July 20 of that year and a fourth was recorded in Island County on July 21. These mortgages were similar in form, stating that they were made in consideration of the advances already made, two at that time, *"and in consideration of further advances to be made."*[3] Additional payments were later advanced, and it was conceded that the surety paid $163,316.75 to complete the contract. Credits received on the contract left a deficit of $569.52 remaining for which an action was initiated. The amount received on the contract was credited to the first advances made; thus the unpaid balance was all advanced on or after December 6, 1955.

October 26, 1955, the United States filed notice of a tax lien in the King County auditor's office, and a similar notice was filed in Island County February 17, 1959. Thus the United States claimed priority in the sale of the mortgaged property in King County. The trial court gave priority to the judgment secured by the surety and the United States appealed. The Washington Supreme Court reversed the judgment below and recognized the priority of the federal tax liens.

In its analysis, the court concluded that the priority of the tax liens was a question to be governed "by the rationale of those Federal cases which held that the lien of a prior mortgage must be subordinated to

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[2] To enable determination of the priorities between federal liens and competing liens the Supreme Court has developed a test of definiteness. This test requires a competing lien to be specific as to identity of the lienor, to be certain as to the amount of the lien, and to be definite as to the property to which it has attached before the competing lien can acquire priority over a federal claim.

[3] 158 Wash. Dec. 335, 337, 363 P.2d 99, 101.

Federal tax liens where the mortgage lien is inchoate at the time the notice of the Federal tax lien is filed."[4]

The court agreed with the trial court's finding that under Washington law there would be no question that the mortgage lien would be first in priority.[5] The propriety of determining priority of mortgages to secure mandatory future advances by relation back to the date of the mortgage is well established by authority.[6] Moreover, the Washington court has exercised a liberal standard in determining whether future advances are mandatory,[7] and there is no doubt that mandatory advances are prior to intervening interests.[8] A standard which will enable a determination at the point of realization is the basic essential of certainty.

The court in *American Surety* went on to say that the relative priority of United States tax liens presented a federal question to be determined by federal courts.[9] The United States Supreme Court's three-fold test of "choateness" was then applied to the mortgage in

[4] *Id.* at 346, 363 P.2d at 106. The court cites four cases in support of this comprehensive statement. United States v. Bond, 279 F.2d 837 (4th Cir. 1960) (mortgagee's claimed priority for payment of real estate taxes accruing after recording of federal tax liens, and further claim for attorney's fee paid in protection of lien of the mortgage were held subordinate to federal lien); United States v. Christensen, 269 F.2d 624 (9th Cir. 1959) (delinquent taxes on mortgaged property paid by mortgagee after federal tax liens were filed against mortgagor-taxpayer. *Held:* federal lien granted priority over taxes so paid); United States v. Ringler, 166 F. Supp. 544 (N.D. Ohio 1958) (mortgage given to secure payment for legal services entitled to priority for those services rendered before recording of federal tax liens, but not as to those thereafter rendered); Metropolitan Life Ins. Co. v. United States, 194 N.Y.S.2d 168 (1959) (federal tax lien granted priority over voluntary payment by mortgagee of local real estate taxes which accrued after recording of tax lien). With the exception of *Ringler,* these cases involve fortuitous occurrences of local tax claims which serve to frustrate their statement in support of the broad principle set out by the Washington court. *Ringler* itself is only one lower federal court decision, and at page 547 states that the Supreme Court has not yet passed upon the priority of a federal tax lien and a mortgage under section 6323.

[5] The trial court relied upon Elmendorf-Anthony Co. v. Dunn, 10 Wn.2d 29, 116 P.2d 253 (1941); Carey v. Herrick, 146 Wash. 283, 263 Pac. 190 (1928); Eltopia Finance Co. v. Colley, 126 Wash. 554, 219 Pac. 24 (1923); Home Sav. & Loan Ass'n v. Burton, 20 Wash. 688, 56 Pac. 940 (1899). On appeal the court recognizes these authorities and further cites 4 POMEROY, EQUITY JURISPRUDENCE § 1199 (5th ed. 1941). A statement on the Washington law is clearly set out in Comment, *Future Advances on Mortgages in Washington,* 18 WASH. L. REV. 24 (1943).

[6] See cases and authorities cited note 5, *supra.*

[7] Shattuck, *Secured Transactions (Other Than Real Estate Mortgages)—A Comparison of the Law in Washington and the Uniform Commercial Code, Article 9,* 29 WASH. L. REV. 1, 32, 33 nn.39 & 40 (1954).

[8] Cedar v. W. E. Roche Fruit Co., 16 Wn.2d 652, 134 P.2d 437 (1943). See Note, 19 WASH. L. REV. 40 (1944).

[9] Note, however, as stated by Judge Whittaker, dissenting in United States v. R. F. Ball Construction Co., 140 F. Supp. 60 (W.D. Tex.), *aff'd,* 239 F.2d 384 (5th Cir. 1956), *rev'd per curiam,* 355 U.S. 587, 593 (1958), that "although the relation of a state-created right to federal laws for the collection of federal credits is a federal question, the State's classification of state-created rights must be given weight. United States v. Security Trust & Savings Bank . . . 340 U.S. at pages 49-50 . . . ."

question. The court reiterated the three elements of definiteness set out by the Supreme Court in 1946.[10] Thus, before the filing of the notice for United States tax liens as required by section 6323 of the Internal Revenue Code of 1954,[11] a competing lien must be definite as to identity of lienor, amount of the lien, and the property to which it attaches, in order to take a preferred position over the tax lien.

The court relied heavily upon *United States v. Ringler*,[12] a decision of a lower federal court which gave a recorded tax lien priority over a mortgage to secure future advances. The court in *Ringler* had admitted that the Supreme Court had not yet passed upon the specific question. The Washington court recognized this limitation but reached the same conclusion as the federal court.

American Surety is a case of first impression in Washington and few similar cases have arisen in the country. It represents the recent trend of aggressiveness displayed by the federal tax authorities in securing the enforcement and priority of federal tax liens over claims of almost every status. The recent attack on the heretofore privileged consensual security is of considerable practical importance and has promoted genuine concern in legal circles.[13]

Consensual lienors are among a limited group of lien holders which has been extended special protection under existing revenue laws.[14] Half a century ago this protection was virtually non-existent since federal tax liens dated back to the time of assessment and took priority

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[10] Illinois *ex. rel.* Gordon v. Campbell, 329 U.S. 362 (1946) (priority of United States for federal insurance contribution taxes granted over lien of State of Illinois for unemployment compensation taxes since the latter was not specific and perfected when the notice of the federal lien was recorded). The Court states at page 375: "The long established rule requires that the lien must be definite, and not merely ascertainable in the future by taking further steps, in at least three respects as of the crucial time. These are: (1) the identity of the lienor, United States v. Knott . . . (2) the amount of the lien, United States v. Waddill, Holland & Flinn Co. . . . and (3) the property to which it attaches, United States v. Waddill, Holland & Flinn Co., supra; United States v. State of Texas, supra; People of State of New York v. Maclay, supra. It is not enough that the lienor has the power to bring these elements, or any of them, down from broad generality to the earth of specific identity."

[11] "(a) Invalidity of lien without notice.—Except as otherwise provided in subsection (c), the lien imposed by section 6321 shall not be valid as against any mortgagee, pledgee, purchaser, or judgment creditor until notice thereof has been filed by the Secretary or his delegate. . . ."

[12] See cases cited and comment thereon, *supra* note 4.

[13] Myers, *The Fall and Rise of the Security Interest*, 6 PRAC. LAW., Dec. 1960, p. 60; Plumb, *Federal Tax Liens: Proposed Revision of the Law*, 45 A.B.A.J. 351 (1959); Plumb, *Federal Tax Liens: Association-Sponsored Bills Reintroduced*, 47 A.B.A.J. 455 (1961); and see particularly Plumb, *Federal Tax Collection and Lien Problems*, 13 TAX L. REV. 247, 459 (1958), for a comprehensive study of this area. Security for future advances is specifically discussed at pp. 495-96.

[14] INT. REV. CODE of 1954, § 6323.

over claims of later good faith encumbrancers who were without knowledge of the existence of these liens.[15] In the light of *United States v. Snyder*,[16] Congress in 1913 extended protection from this secret lien to mortgagees, purchasers, and judgment creditors by requiring that a notice of these taxes be filed before a tax lien could acquire priority over the claims of these three classes.[17] A pledgee was added to the list in 1939.[18] This principle is now embraced in the current law: "the lien imposed by section 6321 shall not be valid as against any mortgagee, pledgee, purchaser, or judgment creditor until notice thereof has been filed. . . ."[19]

Thus, for nearly fifty years, mortgagees have enjoyed at least the advantage of freedom from this secret lien, but this period has also seen the rise of a new doctrine in the Supreme Court for determining priority between federal and competing liens. This doctrine has taken the form of a test of definiteness, the germs of which originated in a 1929 decision[20] and reached full maturity in *Illinois ex rel. Gordon v. Campbell*.[21] In order to defeat a federal priority the competing lien must meet the three-fold test of identity, certainty, and definiteness. If one of these elements is lacking, the federal claim gains priority.

Nevertheless, the usual recorded mortgage[22] still seemed insulated from the impact of federal liens. The security of the mortgagee generally was not challenged by the Government, since the mortgagee enjoyed the protected status under section 6323 whereby notice of a tax lien had to be properly filed before it could be valid against him. In recent decisions the federal courts have begun to encroach upon this supposed sanctuary of consensual security. Applying the test of "choateness" to a mortgage to secure future advances, the federal tax authorities have argued successfully in at least one instance that the amount of the lien was indefinite when the tax notice was filed.[23] The Supreme Court has not yet decided this specific question, but the

[15] In United States v. Snyder, 149 U.S. 210 (1893), the Supreme Court held that an unrecorded tax lien was valid against a purchaser without notice thereof. See INT. REV. CODE of 1954, §§ 6321, 6322 for present law as to the time of attachment of the tax lien.

[16] *Ibid.*

[17] Act of March 4, 1913, ch. 166, 37 Stat. 1016.

[18] Act of June 29, 1939, ch. 247, 53 Stat. 882-83.

[19] INT. REV. CODE of 1954, § 6323(a).

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

[21] Case and comment thereon, *supra* note 10. For an explanation of the development in this area see Kennedy, *The Relative Priority of the Federal Government: The Pernicious Career of the Inchoate and General Lien*, 63 YALE L.J. 905 (1954).

[22] See *e.g.*, RCW 65.08 for typical recording statutes.

[23] United States v. Ringler, 166 F. Supp. 544 (N.D. Ohio 1958).

Washington court in *American Surety* has chosen to follow the small group of cases which apply the "choateness" test to mortgages without attempting to distinguish them.[24] Briefs filed on appeal pointed out that grounds for distinction were found by the trial court.[25]

The Washington court relies especially upon *Ringler,* and although *United States v. R. F. Ball Construction Co.*[26] is referred to, the court fails to note its implication. The actual nine-line Supreme Court opinion in *Ball* did not mention "mortgage" but referred to the document in question merely as an "instrument." It is arguable that this lack of expression indicates an unwillingness on the part of the Supreme Court to pronounce so harsh a result.[27] To this extent then *Ringler* could have been discredited—the Ohio federal district court had "assumed"[28] a more definitive decision by the Supreme Court than actually was rendered when the question presented itself in *Ball.*

The Washington lender on a mortgage to secure future advances

[24] Cases cited *supra* note 4.

[25] Brief for Appellant, pp. 25-27. See also Brief for Respondent, pp. 6-8. *Ringler,* however, is not noted.

[26] 140 F. Supp. 60 (W.D. Tex.), *aff'd,* 239 F.2d 384 (5th Cir. 1956), *rev'd per curiam,* 355 U.S. 587 (1958) (claim of a surety who was a mortgagee under state law held subordinate to unrecorded tax lien. Court said the "instrument" involved was inchoate and unperfected so that section 6323's provisions did not apply). The *Ball* case has provoked sharp criticism as an unprecendented attack on consensual security. Myers, *supra* note 13; AMERICAN BAR ASSOCIATION, FINAL REPORT OF THE COMMITTEE ON FEDERAL LIENS, 3, 4, 14-16, 86-89 (1959); Note, 10 ALA. L. REV. 462 (1958); Note, 27 FORDHAM L. REV. 284 (1958); Note, 33 ST. JOHN'S L. REV. 157 (1958). It appears that the Supreme Court has mitigated the implications of this extreme position in a later decision. United States v. Brosnan, 363 U.S. 237 (1960) (federal tax liens were effectively extinguished by state proceedings to which the Government was not a party). However, the *Brosnan* case was not noted by the Washington court since analogous state proceedings were not involved in *American Surety.* It is mentioned here to illustrate the effect of personalities on the Supreme Court Bench; since both *Ball* and *Brosnan* were 5-to-4 decisions the certainty in this area of law is jeopardized.

[27] As pointed out by the lengthy dissent in *Ball,* there was no question but that the "instrument" in issue was a mortgage under the Texas law. As stated by Myers, *supra* note 13, at 62, "Ball suffered many factual idiosyncrasies. As such it is possible to limit the case to its facts and negate the implications . . . ." Speaking of *Ball,* the dissenting opinion in United States v. Bond, 279 F.2d 837, 850 (4th Cir. 1960) states, "The very fact that the views of the majority were unelaborated in their summary disposition of the issue suggests an absence of an intention to effect a novel extension of a particular rule devised to meet dissimilar conditions. One would suppose that, had the majority intended to decide an important question never before considered by the Supreme Court, it would have stated the considerations which led to its resolution of the issue. It seems more likely than not that the majority in Ball Construction were of the opinion that the assignee was not a mortgagee within the meaning of the statute."

[28] United States v. Ringler, 166 F. Supp. 544, 547 (N.D. Ohio 1958), states, "The Supreme Court has not yet passed upon the question involving the relative priority of a tax lien and a mortgage under Section 3672 where the tax lien was filed subsequent to the recording of a mortgage given to secure future advances. But the court's uniform policy of applying the doctrine of 'the inchoate lien' in cases involving tax liens and judgment liens under Section 3672 seems clearly to forecast a similarly

now finds himself in an unenviable position. Prior to *American Surety*, contracts which required mandatory future advances had been fully protected by the relation back doctrine. This was a sensible result, since under such a contract the extension of future advances is an obligation; the mortgagee has no means of protecting himself against fortuitous events which may occur requiring him to fulfill this mandate. Moreover, it is commonly true of all future advance transactions that it will be essential to the lender's own security to complete the advances contemplated. Future advances become necessary to protect the previous loans and advances made. To grant a tax lien filed after such a mortgage is recorded priority over the advances not then made, but obligatory by contract or necessity upon the lender, is in all respects an unjust result. Further, in light of the purported protection extended by section 6323 such a result seems unreconcilable.

However this may be, there is no doubt that *American Surety* has dictated that in the future the consensual security holder's position in Washington will be a defensive one. Whether the court will retreat from this extreme position remains to be seen, but until it does the Washington attorney will have to take precautionary steps in counseling his lender client. One author has suggested drawing up two mortgages. After-acquired property may not be saved, he states, but the lender will be able to secure specific perfection of the basic security in return for the basic loan.[29]

The few decisions of which *American Surety* is representative have stimulated a state of confusion in the consensual security area. The purpose of the federal tax authorities is avowedly to enforce the existing tax statutes to the end of securing the greatest possible revenue benefits. There is no indication of the point at which this aggressiveness will abate. In the light of these facts the American Bar Association has adopted a Proposed Statute to rectify the areas of indecision and doubt existing in the present Revenue Code.[30] Under this Proposed

strict application of the doctrine in future cases involving the relative priority of United States tax liens and mortgages. It is safe to *assume* that in such a case the three-fold test of choateness . . . will be applied to determine whether a prior recorded mortgage is a perfected lien entitled to priority." (Emphasis added.) Note that section 3672 referred to is the same as section 6323 in the current Code.

[29] Myers, *supra* note 13 at 64. He continues, "subsequent specific mortgages for subsequent present 'future advances' and present 'after-acquired' property can be drawn. So long as these are properly executed prior to assessment of a tax lien, the security will be good." Later the author advises that foreclosure and sale may be the best route for some creditors. *Id.* at 69.

[30] See AMERICAN BAR ASSOCIATION, FINAL REPORT OF THE COMMITTEE ON FEDERAL LIENS, 65, 121, 127 (1959). This A.B.A. sponsored statute has twice been introduced

Statute consensual security will again be returned to its protected status.[31] Until then it is only possible to conclude that *American Surety* has enabled the federal tax lien to become a more menacing threat in the federal tax authorities' arsenal of weapons. Inherent in this decision is a more basic threat to the security of business transactions. While the decline and possible destruction of the security interest is only a remote possibility, reality dictates that credit will become available only on more onerous terms. After half a century of slumber, perhaps it is time for Congress to re-establish protection for consensual security.

BEVERLY J. ROSENOW

Survival of Mortgage-lien on Conditional Vendee's Interest Following Declaration of Forfeiture. In *Norlin v. Montgomery*[1] the Washington court (1) held that a mortgagee of the vendee's interest under a forfeitable real estate contract has a lien on the equity of the vendee, and (2) implied that the lien survives a default by the vendee and a subsequent declaration of forfeiture by the vendor.

As vendee, defendant Montgomery entered a forfeitable real-estate contract with Schy, the vendor. Vendee Montgomery then mortgaged his equity in the contract to plaintiff-mortgagee Norlin who then recorded the mortgage. Thereafter, defendant Palmer purchased the property from Schy and later loaned $1,500 to vendee Montgomery, adding that amount to the real-estate contract payment schedule by endorsement. Then vendee Montgomery defaulted, and Palmer gave written notice of forfeiture. Montgomery executed a quitclaim deed to Palmer with a provision which stated that the intention of the deed was to cancel the contract. Mortgagee Norlin then offered to take over the original Schy-Montgomery contract and to continue the original payment schedule not including the loan of $1,500. After Palmer refused this offer, Norlin brought an action to foreclose his mortgage, and Palmer filed a cross-complaint to quiet title.

Ignoring the issue of Palmer's declaration of forfeiture, the court held:

in Congress: H.R. 7914, H.R. 7915, S. 2305, 86th Cong., 1st Sess. (1959), and H.R. 4319, H.R. 4320, S. 1193, 87th Cong., 1st Sess. (1961). See explanation by Plumb, *supra* note 13.

[31] Security for obligatory, by contract or by necessity, future advances would be entitled unconditionally to the same priority enjoyed under state law. The standard of "choateness" would not be applied. See A.B.A. Report, *supra* note 30, at 65-67, 86-89.

[1] 159 Wash. Dec. 280, 367 P.2d 621 (1961).