

1969

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Recommended Citation

John J. Creedon, *Assignments for Security and Federal Tax Liens*, 37 Fordham L. Rev. 535 (1969).
Available at: <https://ir.lawnet.fordham.edu/flr/vol37/iss4/2>

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Cover Page Footnote

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ASSIGNMENTS FOR SECURITY AND FEDERAL TAX LIENS

JOHN J. CREEDON*

I. INTRODUCTION

SOPHISTICATED financial transactions often assume a form in which the high credit corporation, on which the lender depends for repayment of its loan, is not the borrower. Instead, the credit of the corporation is literally and legally secured by way of an assignment of a lease, charter or other contract under which the high credit corporation is obligated to make payments as lessee, charterer or contract party. As the foregoing suggests, the property financed may range from immovable real estate to a highly mobile ship. In between, property as varied as oil and gas pipelines, coal mines, iron ore, limestone, phosphate, pulp and newsprint has been the subject of these financings. In addition to the garden variety lease and charter, the contracts have received such variegated designations as "take or pay contracts," "take or lend contracts," "thru-put agreements," "supply contracts" and "output agreements." Despite the trappings, the essence is an agreement by the high credit corporation to make periodic payments that are sufficient to repay the principal of the borrower's loan with interest.¹

Financing transactions assume these forms for a variety of reasons. In some, and perhaps most instances, tax considerations are a factor.² Accounting considerations may also influence the high credit corpora-

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1. See, e.g., Anderson, *The Mortgagee Looks at the Commercial Lease*, 10 U. Fla. L. Rev. 484 (1957); Bernard, *Function & Role of the Owner's Lawyer*, 20 Bus. Law. 114 (1964); Clark, *The Lease, The Assignment & The Parties in 100% Financing of Newly Improved Realty*, 18 Ass'n of Life Ins. Counsel 415 (1964); Gustin, *Financing by Contract & by Lease—Some Considerations*, 13 Ass'n of Life Ins. Counsel 685 (1957); Hyde, *The Real Estate Lease as a Credit Instrument*, 20 Bus. Law. 359 (1965); Mendel, *Financing Modern Commercial Structures—Essentials of Documentation*, 12 Bus. Law. 30 (1956); Rodgers, *Ship Construction Financing—Particularly Legal Problems Relating to Security*, 12 Bus. Law. 142 (1957); Simpson, *Ship Financing*, 13 Bus. Law. 145 (1958); Williams, *The Role of the Commercial Lease in Corporate Finance*, 22 Bus. Law. 751 (1967); Williams, *The High Credit Lease as Security—A Lawyer's Viewpoint*, 12 Ass'n of Life Ins. Counsel 1 (1954). For a discussion of the importance of commercial leasing, see Boothe, *The Practical Pros & Cons of Leasing*, 1962 U. Ill. L.F. 1; McGraw & Greenblatt, *Lease Financing of Capital Equipment & Machinery by Business*, 49 Ill. B.J. 630 (1961); Comment, *Equipment Leasing Under the UCC*, 13 U.C.L.A.L. Rev. 125 (1965).

2. Gustin, *supra* note 1, at 685, 698.

tion.³ From the lender's standpoint, these transactions offer an attractive investment outlet, especially if the return is higher than it would be if the money were loaned directly to the high credit corporation.⁴ Moreover, from an economic standpoint, they are an important financial technique employed to create and develop major productive enterprises.

A common variation on the theme is often the shopping center development. Here too, in most instances the developer-owner, who borrows the money and signs the note, is not a financial giant. Before he can obtain a commitment to borrow anything, he must produce a number of major leases with high credit corporations so that the prospective lender will be assured of a flow of rental income which, with other leases anticipated for the development, will be sufficient, after payment of taxes and operating expenses, to service the debt.

To put the problem in perspective, assume a set of facts. Borrower (*B*) asks lender (*L*) for a loan of \$10,000,000 for a term of 30 years to be secured by a mortgage on a warehouse to be occupied upon completion by high credit corporation (*C*) under a long term lease. The lease payments, under the projections made by *B*, will be more than sufficient to pay real estate taxes, operating expenses and principal and interest on the loan. The projections assume that present tax provisions concerning depreciation will continue. *L* agrees to make the mortgage loan but requires that *B*'s rights under the lease be assigned to *L* as security for the loan.

The assignment might be in a separate instrument or it might be contained in the mortgage or deed of trust. Instead of an assignment of the lease, *L* might simply require an assignment of the rents coming due under the lease. Again, the assignment of rents might be in a separate instrument or in the mortgage or trust deed. Where a separate instrument is used, *C* might be a party to the instrument and might make covenants that run directly to *L*. The assignment of the lease or assignment of rents might provide that all or merely a part of the rents coming due will be paid to *L* or to a trustee. The agreement might be that, notwithstanding the assignment, *B* may continue to collect all the rents until *B* defaults under the terms of the loan. These variations may or may not influence the effectiveness of the transaction as against a later federal tax lien filed against *B*. While the variations will be considered later, at this juncture assume the lease is assigned to *L* by a separate instrument and that *L* has the right to collect all the rents from and after the time the loan

3. 2 G. Gilmore, *Security Interests in Personal Property* § 41.1 (1965). A low-credit subsidiary is set up so that the lender may have the benefit of the high credit corporation's credit without establishing a debt that will appear on the high credit corporation's balance sheet. *Id.*

4. Gustin, *supra* note 1, at 685.

is closed and until it is fully repaid, and that *C* has agreed to pay the rents to *L*. Assume further that all rents collected by *L* under the assignment are to be applied to interest and principal on the debt.⁵

Another variation, to be considered later, arises when the collateral assigned is not a lease of, or rent for, real property but a contract or payments due under a contract governed by the Uniform Commercial Code (U.C.C.). Here, a high credit corporation may not be involved at all, but the transaction may simply involve a common, garden variety security interest in contract rights.⁶

Continue now with the assumed statement of facts. *L* makes the loan to *B*, and takes a mortgage and an assignment of *B*'s interest in the lease which are both duly recorded. *L* immediately begins to collect rental payments from *C* and applies them to interest and principal on the debt. Three years later *B*, who has been engaging in other business, becomes delinquent in his federal income taxes. A federal tax lien⁷ is filed against *B* in the county in which the lien is required to be recorded. The United States serves a notice of levy on *C* demanding that future rental payments be paid to the United States rather than to *L*, in order to satisfy *B*'s tax liability.

This article considers the relative priority of an assignment of lease, rents, or contract rights as against a later federal tax lien, particularly with respect to the payments falling due under the lease or contract after notice of the federal tax lien has been filed.⁸ Consideration will first be given to the background of the problem. Next, there will be an explanation of two theories supporting the thesis of this article that the assignment

5. This assumption is made in order to avoid raising and having to consider the effect of the doctrine of *Benedict v. Ratner*, 268 U.S. 353 (1925), which states that any transfer of property as security for a debt which leaves in the transferor the right to control the disposal of the property is a fraud on creditors.

6. Uniform Commercial Code § 9-106 defines "Contract rights" as "any right to payment under a contract not yet earned by performance and not evidenced by an instrument or chattel paper."

7. This article will concern itself with the general tax lien imposed upon a taxpayer for non-payment of federal taxes. It should be noted that there are special liens for estate and gift taxes which differ considerably from the general lien that is the topic of this article. The estate and gift tax liens are contained in Int. Rev. Code of 1954, § 6324(a),(b).

8. For an excellent earlier article on assignments of rents in general agreement with this article see Havighurst, *Relative Priority of Federal Tax Liens & Assignments of Rents in Lease Financings*, 19 Bus. Law. 939 (1964). For other related writing not necessarily in agreement with the present article see generally 2 G. Gilmore, *supra* note 3, at § 40.1-40.6; W. Plumb & L. Wright, *Federal Tax Liens* (2d ed. 1967); Coogan, *The Effect of the Federal Tax Lien Act of 1966 Upon Security Interests Created Under the Uniform Commercial Code*, 81 Harv. L. Rev. 1369 (1968); Plumb, *Federal Liens and Priorities—Agenda for the Next Decade* pts. 1-3, 77 Yale L.J. 228, 605, 1104 (1967-1968).

is valid as against a later federal tax lien: the *no property* theory and the *in esse* theory. The effect of the Federal Tax Lien Act of 1966⁹ on the problem will then be examined. Finally, brief mention will be made of the possible applicability of a purchase money priority.

II. BACKGROUND

If a taxpayer fails or refuses to pay a tax to the federal government after a demand for payment has been made, the Government is given a lien on all "property and rights to property" belonging to the taxpayer.¹⁰ This lien can be foreclosed,¹¹ or the Government may enforce it administratively by way of a levy.¹² In many cases, however, the Government is made a party defendant in the foreclosure of another lien, and in such cases, the Government lien is given effect through the assertion of the appropriate priority against the proceeds produced at the foreclosure sale.¹³

The federal tax lien is effective for some purposes from the date of assessment even though its existence is not disclosed to the taxpayer or the public.¹⁴ Under an early case interpreting the first tax lien statute, a secret federal tax lien was successfully asserted against a subsequent bona fide purchaser more than four years after he had purchased the property from a delinquent taxpayer.¹⁵ Recognizing the inequity, Congress provided in later acts that notice of the federal tax lien had to be filed¹⁶ in order for the lien to be valid as against certain interests.¹⁷ As to other interests, even filing of the federal tax lien was made insufficient; rather, actual knowledge was required.¹⁸ Indeed, in limited circumstances,

9. 80 Stat. 1125 (1966).

10. Int. Rev. Code of 1954, § 6321.

11. Int. Rev. Code of 1954, § 7403.

12. Int. Rev. Code of 1954, § 6331.

13. Int. Rev. Code of 1954, § 7425.

14. Int. Rev. Code of 1954, § 6322.

15. *United States v. Snyder*, 149 U.S. 210 (1893).

16. Int. Rev. Code of 1954, § 6323(f).

17. The first tax lien act passed by Congress permitted the secret lien to have priority over a subsequent bona fide purchaser of the taxpayer's property. Act of July 13, 1866, ch. 184, § 9, 14 Stat. 107. Congress rectified this shortcoming in the law by providing in subsequent acts for the protection of purchasers, mortgagees, judgment creditors, Act of March 4, 1913, ch. 166, 37 Stat. 1016, and pledgees, Revenue Act of 1939, ch. 247, § 401, 53 Stat. 882.

18. Since discovering tax liens by means of searching the files of designated offices was in many cases impractical the Government later developed "superpriorities," namely a class of interests which would prevail even over existing and properly filed tax liens. This class included purchasers of motor vehicles, Int. Rev. Code of 1954, § 6323(b)(2), originating in the Revenue Act of 1964, § 236, 78 Stat. 127, and purchasers and lenders on the strength of "securities," Revenue Act of 1939, § 401, 53 Stat. 882. See generally, Plumb, *supra* note 8, at 229-33.

most recently, even actual knowledge has been determined legislatively not to suffice.¹⁹

The earliest federal tax lien statute did not indicate what priority the federal tax lien was to be given as against competing liens.²⁰ The Supreme Court eventually confirmed, what had long been assumed, that the priority of the federal tax lien was to be governed by the familiar rule, first in time is first in right.²¹ Thus, if there were an earlier lien on the taxpayer's property when the federal tax lien arose, the earlier lien (subject to requirements to be considered) would be entitled to priority.

The first in time, first in right rule of the federal tax lien may seem surprisingly liberal to anyone accustomed to the fact that state and local real estate taxes are secured by liens that are given priority over earlier liens on the property. However, this difference in treatment is essential because of the difference in the taxes. State and local real estate taxes are ad valorem taxes, levied partly to pay for police, fire and other essential services rendered to the property. Generally, they bear a reasonable relationship to the value of the property. However, federal tax liens arise to secure delinquent taxes completely unrelated to any particular property. The delinquency might be for income taxes, withholding taxes or any of a number of different taxes, any one of which could far exceed the value of any or all the property of the taxpayer.²² While a lender can take steps to protect himself against real estate taxes (by lending only part of the value of the property and by checking for the payment of real estate taxes), it would be considerably more difficult to protect against the wide variety of federal taxes which may exceed by far the value of the property and which would be incomparably more difficult to police for payment.

In any event, while the Supreme Court *said* that the priority of the federal tax lien was governed by the first in time, first in right doctrine, starting in 1950²³ it *held* in a series of cases that, for an earlier competing lien to be entitled to priority over a later federal tax lien, the competing

19. Int. Rev. Code of 1954, § 6323(b)(1)-(2).

20. See Act of July 13, 1866, ch. 184, § 9, 14 Stat. 107 where it is stated that "if any person, bank, association, company, or corporation, liable to pay any tax, shall neglect or refuse to pay the same after demand, the amount shall be a lien in favor of the United States from the time it was due until paid, with the interest, penalties, and costs that may accrue in addition thereto, upon all property and rights to property belonging to such person, bank, association, company, or corporation . . ."

21. See *Rankin v. Scott*, 25 U.S. (12 Wheat.) 175, 179 (1827) where Chief Justice Marshall stated: "The principle is believed to be universal, that a prior lien gives a prior claim, which is entitled to prior satisfaction . . ." This principle was first applied in the tax lien field in *United States v. City of New Britain*, 347 U.S. 81 (1954).

22. *United States v. Schroeder*, 204 F. Supp. 199 (S.D. Iowa 1962). While the record does not so indicate, the fact that the federal lien far exceeded the value of the property has been established from the files of the mortgagee, Metropolitan Life Insurance Company.

23. *United States v. Security Trust & Sav. Bank*, 340 U.S. 47 (1950).

lien had to be "choate." This doctrine of the choate lien was developed initially in cases arising under the so-called insolvency priority statute,²⁴ an anachronism dating back to the earliest days of the republic.²⁵

Meeting the Supreme Court's test for a choate lien, which will be considered in greater detail in Part IV, soon became a challenging ordeal. Indeed, there was dicta that perhaps no lien could prevail against the Government under the insolvency priority statute.²⁶ Ingenious lawyers, seeking to protect their clients, sought alternate solutions.²⁷ One that was finally found and assiduously fostered will next be considered.

III. "NO PROPERTY" THEORY

As has been mentioned, a federal tax lien that arises against a delinquent taxpayer attaches to all "property and rights to property belonging to" the taxpayer.²⁸ Obviously and quite rationally, the lien does not attach to property belonging to someone else. However, as in so many areas of the law, stating the rule is easier than applying it.

As the Supreme Court developed the choate lien doctrine to the point where few competing liens against a delinquent taxpayer's property were

24. 31 U.S.C. § 191 (1964).

25. The present statute is in substantially the same form as when enacted in the Act of March 3, 1797, ch. 20, § 5, 1 Stat. 515. Its roots can be traced back even further in the Act of July 31, 1789, ch. 5, § 19, 1 Stat. 42. Later the Act of March 2, 1799, ch. 22, § 65, 1 Stat. 676 was passed. This Act created the companion provision which placed personal liability on one who paid in violation of the priority. The subsequent Act presently exists in 31 U.S.C. § 191 (1964). However, efforts have been recently made to amend the statute. While Congress was considering the passage of the Federal Tax Lien Act of 1966, the ABA recommended changing the insolvency statute. The ABA's effort failed because their proposal was delayed in several Congressional committees. See Coogan, *supra* note 8, at 1380. Despite this setback present attempts are being made to correct the statute. See Report of Committee on Relative Priority of Government and Private Liens, Section of Real Property Probate and Trust Law, ABA, 3 Real Property Probate & Trust J. 209 (1968). See generally Kennedy, *The Relative Priority of the Federal Government: The Pernicious Career of the Inchoate and General Lien*, 63 *Yale L.J.* 905 (1954).

26. See *New York v. Maclay*, 288 U.S. 290, 294 (1932).

27. For example, three theories have been asserted in an attempt to elevate a performance bond surety's claim above the government's with regard to contract funds owed the contractor-defaulting taxpayer. The first is that the surety by paying the contractor's debts which exist as liens against the property of the owner is subrogated to the owner's rights. Included as one of these rights is the right to the retained contract payments which the contractor failed to earn due to his breach of contract. The second is that the surety is subrogated to the rights of the lienholders it has paid off. As a consequence of reimbursing the materialmen the surety is entitled to the benefit of their liens. And the third is that the surety has a secured interest in the contract fund due to an assignment made by the contractor of his rights to the unpaid contract fund. Panel Discussion, *Dangers Under Recent Federal Tax Lien Decisions*, 14 *Bus. Law.* 12, 21-27 (1958); see Creedon, *Federal Tax Liens: A Panel Discussion—Summarized*, 15 *Bus. Law.* 175 (1959).

28. *Int. Rev. Code of 1954*, § 6321.

able to prevail against a later federal tax lien, the bar reacted vigorously against decisions favoring the federal lien and a crescendo of criticism appeared in legal literature.²⁹ Some of the criticism suggested that there was more than a question of lien priorities involved in the decisions; rather, there was a constitutional question of property rights: the Government was taking Peter's property to pay Paul's taxes.³⁰

Perhaps partly in response to that criticism, the Supreme Court began to pay closer attention to the question of whether or not the property or rights to property involved in a dispute in fact "belonged to" the taxpayer. At the same time, the practicing bar sought to develop the *no property* theory. Eventually, the Court may have grasped and expanded the doctrine as a means of escaping from the dilemma created by the choate lien theory which, in the push to its logical conclusion, caused some unfortunate and unfair results.³¹ In any event, decisions were rendered and allowed to stand on the ground that the taxpayer had "no property or rights to property" to which the federal tax lien could attach when, in fact, it would seem he did have some interest in the property for other purposes.

The first case in which the *no property* doctrine attracted attention in the tax lien area was *United States v. Bess*.³² In dispute were life insurance proceeds on the life of a deceased delinquent taxpayer. The taxpayer's

29. See, e.g., 4 A. Corbin, Contracts § 903 (Supp. 1964); Creedon, On Mortgage Foreclosures and Federal Tax Liens, 18 Bus. Law. 1117 (1963); Cross, Federal Tax Claims: Nature and Effect of the Government's Weapons for Collection, 27 Fordham L. Rev. 1 (1958); Friesen, Collection of Federal Taxes Out of the Taxpayer's Property: A Judicial Shell Game, 9 U. Kan. L. Rev. 263 (1961); Kennedy, From Spokane County to Vermont: The Campaign of the Federal Government Against the Inchoate Lien, 50 Iowa L. Rev. 724 (1965); Kennedy, The Relative Priority of the Federal Government: The Pernicious Career or the Inchoate and General Lien, 63 Yale L.J. 905 (1954); MacLachlan, Current Developments Relating to Federal Liens and Priorities, 66 Com. L.J. 265 (1961); Mitchell, The Tax Lien Priority: An Injustice to Creditors, 14 Hastings L.J. 52 (1962); Mitchell, The Choateness Doctrine—Both Unconscionable and Unconstitutional, 38 Conn. B.J. 252 (1964); Myers, The Fall and Rise of the Security Interest, 6 Prac. Law. 60 (Dec. 1960); Plumb, Federal Tax Collection and Lien Problems, 13 Tax L. Rev. 459 (1958); Shanks, The Tax Lien Tamed, 8 U.C.L.A.L. Rev. 339 (1961); Wolson, Federal Tax Liens—A Study in Confusion and Confiscation, 43 Marq. L. Rev. 180 (1959); Note, Federal Priorities and Tax Liens, 63 Colum. L. Rev. 1259 (1963); Comment, Federal Tax Lien Priority: An Injustice to Creditors, 14 Hastings L.J. 52 (1962); Comment, Federal Tax Liens and Assignees of Accounts Receivable: Priority without Reason, 29 U. Chi. L. Rev. 548 (1962); 47 Cornell L.Q. 308 (1962).

30. Plumb, *supra* note 29, at 459.

31. *United States v. Pioneer Am. Ins. Co.*, 374 U.S. 84 (1963); *United States v. Buffalo Sav. Bank*, 371 U.S. 228 (1963); *United States v. White Bear Brewing Co.*, 350 U.S. 1010 (1956). For a discussion of *United States v. Buffalo Sav. Bank*, *supra*, see Creedon, *supra* note 29.

32. 357 U.S. 51 (1958). See also *Commissioner v. Stern*, 357 U.S. 39 (1958) decided the same day as *Bess*.

wife, who was the named beneficiary, claimed that the insurance proceeds were not her deceased husband's property because he had no right to get them when he was alive. His death was necessary before the proceeds could become payable. The Government argued that he owned the policy before his death and that the Government lien attached to his ownership interest before he died. Since he owned the policy and could have changed the beneficiary or otherwise dealt with the policy, the Government felt that the proceeds should be subject to its lien after his death.

The Supreme Court took a middle position and in the process brushed aside some sacrosanct life insurance dogma.³³ It held that under New Jersey law the taxpayer did have "property" in this policy prior to his death, but that his ownership interest gave him only a right to receive the cash surrender value of the policy, *not* the full insurance proceeds. Thus, the Government lien attached to the cash surrender value, and the taxpayer's death did not affect the lien on that value. However, the lien did not attach to the insurance proceeds to the extent they exceeded the cash surrender value, and the wife-beneficiary was entitled to this excess.

On the surface, there appears to be merit to the distinction made by the Court. However, on further analysis the distinction presents difficulties. It is true that the policy owner could have obtained only the cash surrender value *from the insurance company* while he lived. Yet, it must be recognized that the taxpayer was the complete owner of the policy. He could have changed the beneficiary (naming the Government), have sold or transferred the policy or have borrowed on it. The decision does not

33. It is well settled that one who insures another's life is obligated to perform a number of promises, one of which is to pay upon the insured's death the amount of the policy to his beneficiary. Another is to pay the insured the policy's cash surrender value if he chooses to cancel the policy. *United States v. Behrens*, 230 F.2d 504 (2d Cir. 1956). Until the insured elects to cancel the policy and obtain the cash surrender value "it seems apparent under any standard that the insurer holds neither 'property' nor 'rights to property' [in the amount that would be paid if the policy were surrendered] to which a tax lien could attach but is simply the obligor to a broadly based chose in action arising out of a substantially executory contract." *United States v. Sullivan*, 333 F.2d 100, 110-11 (3d Cir. 1964); see *United States v. Metropolitan Life Ins. Co.*, 130 F.2d 149 (2d Cir. 1942); *United States v. Pennsylvania Mut. Life Ins. Co.*, 130 F.2d 495 (3d Cir. 1942); *United States v. Mitchell*, 210 F. Supp. 810 (S.D. Ala. 1962), *aff'd*, 349 F.2d 94 (5th Cir. 1965). Clearly when the insured pays premiums they become the insurer's property, and, therefore, the insured has no property interest in them. Consequently there is no fund of money in the insurer's possession prior to the insured's decision to take the cash surrender value, so there is no fund to which a tax lien could attach. *United States v. Behrens*, 230 F.2d 504 (2d Cir. 1956). "It follows from what we have said that there is no logical escape from holding that the 'surrender value' comes to an end on the insured's death, if we dispose of the controversy in accordance with the ordinary rules governing contracts." *Id.* at 506-07.

indicate the facts surrounding the insured's death. Suppose, however, he knew and could have established to a third person's satisfaction that he was near death. Can there be any doubt that the policy value would then be greater than the cash surrender value and *that he could have realized such value*? He still would not have been able to obtain the insurance proceeds from the insurance company but he could have obtained a sum close to that amount from someone else. To hold then that his death eliminates the tax lien from all policy value other than the cash surrender values seems somewhat inconsistent with the decision that his death left unaffected the lien on the cash surrender value. Nevertheless, the decision is grounded on the remedies of lien creditors generally and perhaps partly on public policy.

In *Bess*, the Court stressed two doctrines. First, it held that in deciding whether or not there is "property or rights to property" belonging to the taxpayer the courts must look to state law. While perhaps not entirely clear from the opinion, especially in the light of later developments, the Court seemed to indicate that once the nature of the rights and interests of the taxpayer have been determined under state law, then federal law would determine whether or not such rights and interests constitute "property or rights to property" to which a federal tax lien will attach.³⁴ Second, *Bess* held that once it is decided that the taxpayer has "property or rights to property," the consequences of the federal tax lien attaching to that property are a matter of federal law.³⁵

The next *no property* doctrine cases considered by the Court were *Aquilino v. United States*³⁶ and *United States v. Durham Lumber Co.*³⁷ The former, a New York case, came up through the state courts;³⁸ the

34. Apparently the *Bess* court concluded that it was clear under New Jersey law that an individual who could not realize the proceeds of an insurance policy had no property rights to the proceeds. Consequently, the Court felt no need as it did in *Aquilino* to remand the case for a determination by the state courts of the state law on the subject.

35. Under state law the insured's contract right would disappear when he died. See cases cited note 33, *supra*. A consequence of the application of state law, therefore, would be that a tax lien existing during the taxpayer's life would be cut off by his death. The Supreme Court held, however, that once a federal tax lien attaches the consequences of that attachment are to be determined by federal not state law. The Court solved the difficult conceptual problem that the cash surrender value disappeared upon the death of the insured by stating that the "cash surrender value should be treated for some purposes as though in fact a 'fund' held by the insurer for the benefit of the insured." *United States v. Bess*, 357 U.S. 51, 59 (1958). Therefore, the Court applied federal law to determine the consequences of the attachment.

36. 363 U.S. 509 (1960).

37. 363 U.S. 522 (1960).

38. *Aquilino v. United States*, 2 App. Div. 2d 747, 153 N.Y.S.2d 268 (1st Dep't 1956), *rev'd*, 3 N.Y.2d 511, 146 N.E.2d 774, 169 N.Y.S.2d 9 (1957).

latter, a North Carolina case, involved a bankruptcy action and took the federal court route.³⁹ Both involved the claims of subcontractors against funds held by owners of real estate who had contracted for certain improvements. The contractor in each case defaulted both under the subcontract and in the payment of his federal taxes. The Government and the subcontractors claimed the funds held by the property owners. The subcontractors (whose liens arose *after* the federal tax liens were filed against the contractor-taxpayers) argued that the Government liens did not attach to the funds in dispute because the contractor-taxpayer had no "property right" in the funds. The Government argued that the subcontractors' liens arose after the federal liens and were inchoate. The New York Court of Appeals agreed with the Government;⁴⁰ the Fourth Circuit Court of Appeals sided with the subcontractors.⁴¹

The Supreme Court fell back on *Bess*.⁴² It held that in deciding whether or not the funds were property belonging to the taxpayer, it was necessary to consult applicable state law. The fourth circuit had already considered state law and decided in the negative so the Supreme Court affirmed.⁴³ New York had not sufficiently considered state law influences so the Court remanded.⁴⁴ The New York Court of Appeals was directed to explore and determine whether under applicable lien law the contractor-taxpayer holds bare legal title to the sum due from the owner, as trustee for the subcontractor, or whether it has full ownership of the debt, subject only to a lien in favor of the subcontractor. As was perhaps to be expected, on remand, the New York Court of Appeals held that the contractor-taxpayer had no "property" interest in the funds.⁴⁵

A closer analysis of *Aquilino* on remand may be in order. Involved was the construction of earlier trust fund provisions of New York's Lien Law.⁴⁶ They provided that "[t]he funds received by a contractor from an owner for the improvement of real property . . . constitute trust funds in the hands of such contractor to be applied first to the payment of claims of subcontractors. . . ."⁴⁷ However, the trust was not a trust "of the usual kind." The features that caused its departure from normalcy were:

39. *United States v. Durham Lumber Co.*, 257 F.2d 570 (4th Cir. 1958), *aff'd*, 363 U.S. 522 (1960).

40. *Aquilino v. United States*, 3 N.Y.2d 511, 146 N.E.2d 774, 169 N.Y.S.2d 9 (1957).

41. *United States v. Durham Lumber Co.*, 257 F.2d 570 (4th Cir. 1958).

42. *United States v. Bess*, 357 U.S. 51 (1958).

43. *United States v. Durham Lumber Co.*, 363 U.S. 522 (1960).

44. *Aquilino v. United States*, 363 U.S. 509 (1960).

45. *Aquilino v. United States*, 10 N.Y.2d 271, 176 N.E.2d 826, 219 N.Y.S.2d 254 (1961).

46. Ch. 859, § 18, [1930] N.Y. Laws 1603, as amended N.Y. Lien Law §§ 70-79 (1966).

47. *Aquilino v. United States*, 10 N.Y.2d 271, 275, 176 N.E.2d 826, 828, 219 N.Y.S.2d 254, 257 (1961).

“(1) that the contractor-trustee is not under the necessity of holding the fund intact until the improvement is completed, required as he is to pay the claims of the subcontractors as they mature; (2) that the contractor-trustee may, under specified conditions, assign his rights to future payments due from an owner . . .; (3) that the contractor-trustee is privileged to commingle funds . . .; and (4) that the remedy available is a class action rather than one prosecutable by an individual. . . .”⁴⁸ Judge Fuld had little difficulty in reasoning that none of these four features gave the contractor any “property interest” in the fund. Rather he found: “[S]uch funds are to be ‘applied first’ to the payment of the statutory beneficiaries. *The contractor has a beneficial interest only in so much of the proceeds as remain after the claims of all beneficiaries have been settled.*”⁴⁹ Presumably Judge Fuld concluded that the taxpayer held “bare legal title” to the sum due from the owner rather than “full ownership of the debt, subject only to a lien in favor of the subcontractor.”

While the result in *Aquilino* certainly seems sound from a policy standpoint, the decision is not without its logical difficulties. True, the contractor was required to pay the subcontractors first, but clearly, after paying them, the contractor was entitled to the proceeds. Prior to paying them did he have an existing right to property, that is, the right to the proceeds after paying the subcontractor? Obviously, the right to keep the proceeds was subject to a condition. But was not this right a thing of value? Could not it have been transferred for value? If so, would not the federal tax lien have attached to that right whenever it arose? If so, on the reasoning in *Bess*,⁵⁰ would not the consequences of the tax lien attaching be a matter of federal law, so that when the contractor failed to pay the subcontractors, the effect of that failure vis-à-vis the federal lien would be federally determined? The contrary reasoning might be that the contractor had no right to property *until* he paid the subcontractors. Is the holding then that a right to property that is conditional is not a right to which a federal tax lien will attach?⁵¹

Furthermore, the holding that the contractor did not have a sufficient beneficial interest in the fund to constitute “property or a right to property” in the proceeds seems somewhat inconsistent with his power to assign the proceeds under conditions specified in the Lien Law and thereby defeat the rights of the subcontractors. Would such an assignee also defeat an existing federal tax lien against the assignor? Although Judge Fuld masterfully and persuasively rationalized the result on trust principles,

48. *Id.* at 280, 176 N.E.2d at 831-32, 219 N.Y.S.2d at 261.

49. *Id.* (emphasis added).

50. *United States v. Bess*, 357 U.S. 51 (1958).

51. See *In re Halprin*, 280 F.2d 407 (3d Cir. 1960) for a holding to such effect.

an uneasy feeling remains that a contractor has something more than bare legal title. Suppose a borrower and lender agreed in a particular transaction that all of certain moneys to be received by the borrower would be held "in trust" for the benefit of the lender. Would such a trust be any less effective than the statutory trust provided in the Lien Law? No persuasive reason for a different result is immediately apparent. In each case, the taxpayer would have the right to the trust funds only after a third party was paid first. To distinguish because of the nature of the contract between the taxpayer and the third party would seem specious. And if the result would be the same, does the magic word "trust" dictate the result or can the same result be reached if the taxpayer's substantive rights are substantially the same although the form of the transaction is somewhat different? More will be said about this question later.⁵²

In *Durham Lumber*, the fourth circuit court reached the same result as in *Aquilino* without benefit of the trust fund doctrine. Instead, it was stressed that the subcontractors had an independent cause of action against the property owners.⁵³ Thus, the subcontractors were claiming their own property from the owners and not the contractor's property. Here too, however, the contractor clearly had some rights against the owner, both before the subcontractors gave notice of their claims to the owners and, contingently, after the subcontractors were paid.

Finally, in *Aquilino* and *Durham Lumber* the relationship between state law and federal law in determining what is "property or rights to property" was not articulated as clearly as it had been in earlier cases on which *Bess* relied⁵⁴ and, indeed, even as clearly as in *Bess* itself.⁵⁵ In *Aquilino* the Court indicated that state law is to be applied "in ascertaining the taxpayers' property rights. . . ."⁵⁶ Then it remanded so that the New York courts could "ascertain the property interests of the taxpayer under state law and then dispose of the case according to established principles of law."⁵⁷ Also in *Durham Lumber* the Court indicated that the fourth circuit's "characterization of the taxpayers' property interests" under North Carolina state law was not clearly erroneous or unreasonable.⁵⁸

52. See text accompanying notes 69-72 *infra*.

53. *United States v. Durham Lumber Co.*, 257 F.2d 570, 573 (4th Cir. 1958).

54. See *Fidelity & Deposit Co. v. Housing Authority*, 241 F.2d 142 (2d Cir. 1957). See also *Morgan v. Commissioner*, 309 U.S. 78 (1940).

55. Justice Brennan stated that "[s]ince § 3670 creates no property rights but merely attaches consequences, federally defined, to rights created under state law, . . . we must look first to Mr. Bess' right in the policies as defined by state law." *United States v. Bess*, 357 U.S. 51, 55 (1958).

56. *Aquilino v. United States*, 363 U.S. 509, 514 (1960).

57. *Id.* at 516.

58. *United States v. Durham Lumber Co.*, 363 U.S. 522, 527 (1960).

These cases have been interpreted as holding that state law determines whether or not there is "property or rights to property" to which a federal tax lien will attach.⁵⁹ It would seem, however, that state law should merely determine what rights and interests the taxpayer has and that federal law should determine whether those rights or interests constitute property to which the tax lien will attach. Judge Fuld's decision in *Aquilino*, on remand, can be interpreted as making this dual determination.

It is possible but doubtful that the Court meant to leave to state law the determination of whether or not the taxpayer has "property or rights to property" that are subject to the tax lien. It is one thing to hold that federal law does not create rights; it is another to hold that a state's characterization of rights as "property" or "no property" will necessarily control. For example, in *Milton Savings Bank v. United States*,⁶⁰ the Massachusetts Supreme Judicial Court clearly indicated that mortgaged real estate is not property of the taxpayer. Under Massachusetts law, the mortgagor has "merely an equity of redemption accompanied by a right to possession."⁶¹ Despite this pronouncement a lower federal court refused to so hold in a tax lien case.⁶²

Characterizing the rights and interests of a taxpayer as "property" or "no property" would seem to involve a difficult determination at best, whether federal, state or both federal and state law apply. As pointed out in Justice Harlan's dissent in *Aquilino*, leaving the matter partly to state law invites "dubious distinctions."⁶³ How many rights must be in the taxpayer's bundle and what must be their nature and shape before they are to be classified as "property"? Nevertheless, the Court's decision that federal law does not "create" rights seems clearly sound; therefore one is forced to look to state law for a determination of what rights exist.

Assuming that federal law is to determine whether or not state-created rights are to be classified as property for federal tax lien purposes, what standards, if any, do *Bess*, *Durham Lumber*, and *Aquilino* suggest will influence the determination? In *Bess*, the cash surrender value which could have been obtained during the taxpayer's life was held to be property; the insurance proceeds, which were contingent on his death, were held not to be property. The fact that the taxpayer owned all rights under the policy and could have transferred it for value, either outright or as security, did not affect the classification of the insurance policy. Perhaps then the standard is that the federal tax lien does not attach to rights the

59. See Young, Priority of the Federal Tax Lien, 34 U. Chi. L. Rev. 723 (1967).

60. 345 Mass. 302, 187 N.E.2d 379 (1963).

61. Id. at 305, 187 N.E.2d at 381.

62. *United States v. Rahar's Inn, Inc.*, 243 F. Supp. 459 (D. Mass. 1965).

63. *Aquilino v. United States*, 363 U.S. 509, 521 (1960) (dissenting opinion).

exercise of which is subject to a contingency, even though such rights may be of value for some purposes. In *Aquilino* the taxpayer had certain rights in the contract proceeds. He could have assigned them under certain circumstances and defeated the subcontractors' rights. He would have been entitled to them after the subcontractors were paid. Here too then, the taxpayer's right was conditional, and it also could have been of value. In *Durham Lumber* the taxpayer's rights were also conditioned on the subcontractors' being paid first, and it was stressed that the subcontractors had direct rights against the owners. Consequently, whether the federal tax lien attaches might depend in part on the nature of the interest of the competing party.

Several days after the Court decided *Aquilino* the Third Circuit Court of Appeals decided *In re Halprin*.⁶⁴ There, Halprin, a manufacturer, contracted with Doniger and Company to sew and complete jackets. Under the contract, Halprin was to receive a fixed sum upon delivery of the jackets. On February 2, 1956, after the contract was made, a notice of federal tax lien was filed against Halprin. Still later, Halprin borrowed money from Commercial Sales, Inc. to meet current payrolls. Halprin irrevocably assigned to Commercial as security for the loan all sums to become due under the contract with Doniger. Doniger was notified of the assignment and agreed to pay Commercial all sums due under the contract. Thereafter, Halprin delivered some jackets under the contract to Doniger and the money owed by Doniger under the contract was claimed by both the Government under its tax lien and by Commercial under its assignment.

The third circuit first decided that the federal tax lien did not attach to the executory contract between Halprin and Doniger. Such a wholly executory contract, said the court, was not property to which the federal tax lien would attach, again reflecting the principle that the tax lien does not attach to a contingent or conditional right. Next the court held that the assignment by Halprin to Doniger created a valid security interest under the U.C.C. Furthermore, it observed that Doniger's agreement to pay Commercial gave Commercial a direct right against Doniger and that Halprin "ceased to be entitled even formally, much less beneficially, to receive Doniger's performance."⁶⁵ Therefore, before Halprin had any property under the contract to which the federal tax lien could attach, Halprin had transferred all monies due under the contract to Commercial. A final point made by the court was that the loan from Commercial was used to finance Halprin's contract with Doniger so that Commercial might

64. 280 F.2d 407 (3d Cir. 1960).

65. *Id.* at 409.

equitably be regarded as entitled to a "purchase money priority" as against competing claimants.

Unfortunately, *In re Halprin* was not appealed to the Supreme Court. To date, however, it stands as the most direct authority for application of the *no property* theory to an assignment for security purposes. Understandably, except for the purchase money aspects, *Halprin* is a difficult case for the Government because it seems to enable a taxpayer to assign future monies effectively even *after* a federal tax lien has arisen.

There is also contrary authority, although it is probably only dicta. In *United States v. L.R. Foy Construction Co.*,⁶⁶ the tenth circuit expressly rejected the *no property* theory but nevertheless held for the assignee on the ground that it held a "choate" lien. In *Foy* the bank's assignment antedated the federal tax lien but part of the taxpayer's indebtedness to the bank was contracted after notice of the tax lien was filed. The bank urged the *no property* theory presumably hoping that its acceptance would result in protection of the full indebtedness as against the tax lien. In reversing, the tenth circuit found that the assignment was the equivalent of a mortgage; hence the taxpayer had "property" in the form of an equity of redemption. Accordingly, the bank-assignee was entitled to priority over the later federal tax lien only to the extent that its lien was choate as of the date of tax lien filing. The same result could have been reached by holding that the taxpayer had "no property" in the fund to the extent that the fund had been assigned for debt existing as of the date of the tax lien filing. Such a result would be completely consistent with the rationale in *Aquilino*, and a comparable result presumably would be reached in an *Aquilino* type of case if the subcontractor had two claims against the fund held by the property owner, one of which was entitled to trust fund protection and the other of which was a claim of lesser dignity.⁶⁷

66. 300 F.2d 207 (10th Cir. 1962).

67. The decision in *Crest Fin. Co. v. United States*, 368 U.S. 347 (1961) (per curiam), considered later, would not seem to be authority against application of the "no property" theory to assignments for security. The "no property" argument was made at several levels, but the case was ultimately decided in favor of the finance company on the basis that it had a choate lien. In *Crest Finance* the government conceded that the assignments created a choate lien entitled to priority over the tax lien. The government in its memorandum stated that this "concession makes it unnecessary to consider petitioner's alternative contention here . . . that the taxpayer had no 'property' interest in the assigned accounts to which the tax lien could attach. We may note, however, that that argument, made for the first time in the petition for rehearing in the court of appeals in an effort to bring this case within the rationale of *United States v. Durham Lumber Co.*, 363 U.S. 522, and *Aquilino v. United States*, 363 U.S. 509, is foreclosed by the stipulation and district court finding that the amounts due on the contract 'belonged' to the taxpayer. . . . Nor do we agree that the result in this case is inconsistent . . . with *In re Halprin*, 280 F.2d 407 (C.A.3), and *City*

Where does this review of the case law on the *no property* doctrine lead as far as assignments for security are concerned? Reverting to our assumed set of facts⁶⁸ we find that on the date the federal tax lien arose, the lease and all payments coming due under it had been assigned as security for the loan. The tenant *C* under the lease agreed with *L* to pay the rents directly to *L*. As in *Aquilino*, *B* has no right to the rents until *L* is paid. As in *Durham Lumber*, *L* has the right to proceed directly against *C*. If anything *L*'s rights are stronger than in *Halprin* because the assignment of the lease antedated the federal tax lien.

Should a distinction be made between the *Aquilino* and *Durham Lumber* cases and our assumed facts, as was made in *Foy*, that an assignment for security is really a mortgage from which the assignor has an equity of redemption? Should it make a difference whether the lender is deemed to have title or merely a lien under applicable state law? Hopefully, the *label* will not control. Is the assignment of lease and payments due thereunder merely a mortgage or pledge or is it something more? A mortgage is a conveyance of property as security for a debt, which, depending on applicable state law, conveys title or creates a lien.⁶⁹ One usually thinks of a mortgage in terms of real or tangible personal property. The mortgaged property constitutes security, in the sense that if the mortgagor fails to pay the debt, his equity of redemption may be foreclosed either by a foreclosure sale or other procedure and the proceeds of sale applied against the debt. Is this the kind of interest that an assignee of a lease, rents or contract rights has? Clearly, he has something more. Under our assumed facts, *L* is actually collecting the rents due under the lease and applying them to the debt. He does not sell them upon default; he has an operative assignment which gives him full rights to the rents as against *B* and *C*. He can sue *C* for the rents; he has parted with money in consideration of the assignment. *B* has no right to the rents until *L* is paid, just as in *Aquilino* and *Durham Lumber* the contractors had no right to the contract proceeds until the subcontractors were paid. Actually in *Aquilino* the contractor had greater rights than *B*. The contractor could have obtained the money but would have had to hold it in trust. *B* has no right to the rents at all until *L* is paid. It is submitted, therefore, on the authority of *Aquilino* and *Durham Lumber*, that a taxpayer who has assigned a lease under the conditions set forth in the assumed facts⁷⁰

of New York v. United States, 283 F.2d 829 (C.A.2). In *Halprin*, the court found a novation, and in *City of New York*, there had been a recorded absolute assignment to a general assignee for the benefit of creditors, who administered the property under court supervision." Memorandum for the United States at 9 n.4, *Crest Fin. Co. v. United States*, 368 U.S. 347 (1961).

68. See text accompanying note 5.

69. 59 C.J.S. Mortgages § 1b(1),(2) (1949).

70. See text accompanying note 5.

should generally be regarded under state law as having effectively assigned the lease and rents due thereunder and that his conditional right to get the rents after paying *L* should not be regarded as "property or rights to property" to which a federal tax lien will attach under the federal law. To hold otherwise, as suggested in *Foy*, would seem to place undue emphasis on form and not enough on substance. Labels such as title, lien, security and property should not obscure the essential, substantive rights involved. The federal tax lien competes against numerous kinds of conflicting interests. In *Aquilino*, the taxpayer had a contract with an owner and a subcontractor. In the assumed facts,⁷¹ the taxpayer has a contract with a tenant and a lender. In each case, the contracting parties had rights superior to those of the taxpayer. The label placed on those rights should not control whether or not the tax lien attaches. Nothing in the Internal Revenue Code would seem to require that result.

Turning now to some of the variations mentioned earlier,⁷² the same result should obtain whether there is an assignment of a lease, rents, a contract or payments due thereunder. If the lender has advanced his loan prior to filing of the federal tax lien and if applicable state law validates the assignment so that the taxpayer has no right to the funds until *L* has been paid, there would seem to be no reason to distinguish these cases. Whether the assignment is in the mortgage, the deed of trust or in a separate instrument, and whether the high credit corporation is a party to the instrument or not, as long as *L* has the right under state law to collect the payments and apply them to its debt, it would seem that the federal tax lien should not attach to *B*'s conditional right to get the rents. Finally, the result should be the same whether *C* is obligated to pay *L* or *L*'s trustee.

If the facts are changed, so that *B* does have the right to collect the rents until a default occurs, then it would seem that the *no property* doctrine should be inapplicable. The federal tax lien would attach to *B*'s property, including the right to receive the rents, and the relative priority of the tax lien and *L*'s claim to the rents would be decided under federal tax lien law. Query, whether *L* could assert the *no property* doctrine, if the language of assignment required *B* to hold all rents "in trust" for *L* after a default has occurred and state law validated such a trust?

IV. "IN ESSE" THEORY—PRE-1966—THE CHOATE LIEN DOCTRINE

If the threshold question⁷³ of whether the taxpayer has "property or rights to property" is, despite the foregoing analysis, decided in the affirmative, then *L* must seek other grounds for claiming priority over the

71. *Id.*

72. *Id.*

73. See *Aquilino v. United States*, 363 U.S. 509, 512 (1960).

subsequent federal tax lien. Before considering the present statutory provisions which should control *L*'s fate, it seems desirable to review the doctrine of the choate⁷⁴ lien briefly and particularly its impact on the area of assignments. Such review may have special merit because there are indications that the choate lien doctrine survived the Federal Tax Lien Act of 1966,⁷⁵ except to the extent the Act provided otherwise.⁷⁶

On numerous occasions before passage of the Federal Tax Lien Act of 1966, the Supreme Court made it clear that if a competing lien against a taxpayer was to take priority over a Government lien, the competing lien had to be choate.⁷⁷ At times, the Court alternated and said the competing lien had to be perfected.⁷⁸ In either event, the Court required as a minimum that the amount of the lien, the property subject to the lien and the

74. A great deal of interest and controversy has arisen from the Supreme Court's use of the word "choate." The Court of Appeals for the Second Circuit in *Hammes v. Tucson Newspapers Inc.*, 324 F.2d 101, 102 n.1 (9th Cir. 1963) commenting upon it stated that "[w]e do not find it particularly couth, and use it only because the Supreme Court has revived it in federal tax lien cases." Mr. Plumb, one of leading authorities in the field, has indicated that the word "choate" apparently was not listed in most dictionaries until it was placed in vogue by the Supreme Court, giving rise to the implication that prior to the Supreme Court's use of the word it had no existence. Plumb believes that the word was incorrectly derived from "inchoate" by dropping a prefix that means "on" rather than "not." Plumb, *supra* note 8, at 230 n.15. "Inchoate" is derived from the Latin "incohatus" which means to grasp or "only begun." Since "inchoate" can be defined as meaning incomplete it was easy to be misled into concluding that inchoate also meant not choate. Consequently, Webster 2d listed choate as a "rare" meaning for complete. In Webster 3d the classification of "rare" was dropped. D. Mellinkoff, *The Language of the Law* 76 (1963). Under the foregoing reasoning there is no Latin word "cohatus" or "choatus," and its equivalent does not appear in any other language. Letter from F. Stuart Crawford to John Creedon, Jan. 31, 1966. H. F. Birnbaum disagrees. He suggests that the word "choate" has the Greek root "choo" which means "heap or pile up." Therefore, the "in" prefixed to "inchoate" may be used in the negative sense. Inchoate means not fully heaped or piled up and so "means begun as distinguished from completed." Letter from H. F. Birnbaum to William T. Plumb, June 2, 1958. Consequently the word still remains a topic for debate.

75. In H.R. Rep. No. 1884, 89th Cong., 2d Sess. 35 (1966) it was stated that "[u]nder decisions of the Supreme Court a mortgagee, pledgee, or judgment creditor is protected at the time notice of the tax lien is filed if the identity of the lienor, the property subject to the lien, and the amount of the lien are all established at such time. See *United States v. City of New Britain* . . . Except as otherwise provided, subsection (a) of new section 6323 retains this basic rule of Federal law." See Coogan, *supra* note 8, at 1381; Plumb, *supra* note 8, at 232.

76. H.R. Rep. No. 1884, *supra* note 75.

77. *United States v. Vermont*, 377 U.S. 351 (1964); *United States v. Pioneer Am. Ins. Co.*, 374 U.S. 84 (1963); *United States v. White Bear Brewing Co.*, 350 U.S. 1010 (1956) (*per curiam*); *United States v. City of New Britain*, 347 U.S. 81 (1954); *United States v. Security Trust & Sav. Bank*, 340 U.S. 47 (1950).

78. See *United States v. City of New Britain*, 347 U.S. 81 (1954).

identity of the lienor be certain.⁷⁹ The time at which the competing lien had to have these attributes of certainty varied in varying circumstances.⁸⁰ Moreover, it has been suggested that there may be additional requirements for a competing lien to be choate,⁸¹ if the lien is competing against the Government's priority under the so-called insolvency priority statute.⁸²

The requirements that the amount of the lien and the identity of the lienor be certain when notice of the federal tax lien is recorded pose no problem under our assumed facts.⁸³ *L* is the holder of the lien and he has advanced \$10,000,000 long before tax lien filing. The third requirement of specificity of the property subject to the lien requires closer analysis.

This question was before the Court in the interesting and unique case of *Crest Finance Co. v. United States*.⁸⁴ Twin, a subcontractor, had contracted with Standard to supply labor and materials for the construction of an Illinois Toll Road. During March and June of 1958, Crest Finance loaned over \$67,000 to Twin and took an assignment of the account receivable from Standard as security for the loan. Standard was notified of the assignment and made some payments directly to Crest. The United States filed notice of a tax lien against Twin on October 9, 1958. A dispute arose as to the relative priority of the assignment for security and the later tax lien. As of the date of tax lien filing, the exact amount of the assigned account receivable had not been definitely determined, although Twin had performed the work. It was later determined to be \$17,369.94. The Government argued that the assignment of the account receivable was an inchoate lien because the property subject to the lien was not fixed and certain as of the date of tax lien filing—the exact amount of the account receivable being unknown.

The district court found for the United States.⁸⁵ The Court of Appeals for the Seventh Circuit affirmed⁸⁶ on the ground that Crest Finance's lien was inchoate, citing, *inter alia*, *R. F. Ball Construction Co. v. United*

79. *Id.*

80. Under the tax lien statute the non-federal lien had to be perfected at the time when the tax lien arose. However, if the lienholder were a mortgagee, purchaser or judgment creditor perfection did not have to take place until notice of the tax lien was filed by the collector. See Int. Rev. Code of 1939, ch. 36, §§ 3670, 3672, 53 Stat. 449 (now Int. Rev. Code of 1954, §§ 6321, 6323(a)).

81. See *United States v. Waddill, Holland & Flinn, Inc.*, 323 U.S. 353, 358 (1945).

82. 31 U.S.C. § 191 (1964).

83. Since in most security arrangements involving high credit leases and contracts the debt (hence the amount of the lien) is specific, the amount of the lien, seldom causes problems. See Havighurst, *supra* note 8, at 953.

84. 368 U.S. 347 (1961) (*per curiam*).

85. See *United States v. Crest Fin. Co.*, 291 F.2d 1 (7th Cir. 1961).

86. *Id.* at 5.

States.⁸⁷ Crest Finance petitioned for certiorari to the Supreme Court. Solicitor General Cox then submitted a memorandum to the Court admitting that the Government had argued the case incorrectly before the seventh circuit and that *Ball* was not controlling. He suggested that the Court remand so the circuit court could determine whether the assignment of the account receivable had to be recorded under Illinois law to be effective. If recording was not necessary, the Solicitor General conceded that the assignment for security was a choate lien according to principles enunciated by the Court in *United States v. City of New Britain*.⁸⁸

As indicated, the amount of the account receivable was not known at the time of tax lien filing. It was to be determined on the basis of estimates of the quantity of dirt transported to the construction site and subject to subsequent revision by an engineer's measurement. The Solicitor General analyzed whether or not the possible change by the engineer in the amount owing on the assigned claim made the assignment "inchoate." In concluding it did not, he stated:

87. 355 U.S. 587 (1958) (per curiam). The case involved an assignment by a subcontractor of all its right to payments under a subcontract with Ball Construction. The assignment was to the performance-bond surety as security for any payments the surety might have to make owing to the subcontractor's default on the contract or for any other indebtedness that might arise between the subcontractor and the surety. Later the subcontractor entered into another contract, not involving Ball Construction and the surety executed a second performance bond on April 4, 1953. By April 30, 1953 Ball owed the subcontractor \$13,228.55. In May, June, and September of 1953 the federal government filed notice of tax liens against the subcontractor. Subsequently the subcontractor defaulted on the second contract owing the surety \$12,971.88. The surety alleged that the assignment gave it the rights of a mortgagee under then § 6323(a). This section states that a tax lien is not valid as against a mortgagee, pledgee, purchaser or judgment creditor until notice of the tax lien is filed. The Supreme Court in a per curiam decision which stated no facts or principles of law reversed the lower court decisions and held the statute not applicable because the instrument involved was inchoate and unperfected.

One of the basic problems with the *Ball* decision lies in the Court's neglect to explain the basis upon which the surety's lien was held inchoate. Several reasons for the Court's decision could be argued, see Kennedy, *From Spokane County to Vermont: The Campaign of the Federal Government against the Inchoate Lien*, 50 Iowa L. Rev. 724, 734 (1965), and much confusion resulted. See 4 A. Corbin, *supra* note 29, at § 903 (Supp. 1964). The Court presented its own interpretation of the case in *United States v. Pioneer Am. Ins. Co.*, 374 U.S. 84 (1964). The Court explained that the surety's lien was inchoate because the amount of the lien was uncertain at the time the tax lien arose. Moreover, commentators generally felt that the lien in *Ball* was inchoate because the amount of the lien was indefinite at the time the tax lien was filed. See Burroughs, *The Choate Lien Doctrine*, 1963 Duke L.J. 449; Clark, *supra* note 1, at 459.

88. 347 U.S. 81 (1954). The Court stated that "[t]he liens may also be perfected in the sense that there is nothing more to be done to have a choate lien—when the identity of the lienor, the property subject to the lien, and the amount of the lien are established." *Id.* at 84.

Just as a mortgage on real estate is not made inchoate because the value of the property . . . is uncertain, so the petitioner's lien on the taxpayer's contractual right to payment for work performed is not made inchoate because the amount payable on the assigned right has not been finally ascertained. *The requirement of definiteness of amount goes only to the debt secured by the lien, not to the property (otherwise specifically identified) that is subject to the lien.*⁸⁹

The Supreme Court agreed with the Solicitor General's opinion that the lien was choate and vacated the judgment.⁹⁰ On remand, the court of appeals (understandably reflecting some annoyance with the Government's about face)⁹¹ held that the assignment to Crest Finance was perfected under Illinois law without filing and was entitled to priority over the later federal tax liens. On its facts, *Crest Finance* is a holding that an assignment for security of an amount not determined as of the date of tax lien filing meets the test of specificity of property required under the choate lien doctrine where the amount represents payment for work performed.

A similar case was *Hammes v. Tucson Newspapers, Inc.*⁹² There, a taxpayer assigned as security certain installment payments to become due under a contract for the sale of real property. While all the circumstances are not clear from the decision, the contract was apparently executory and some additional performance was due from the taxpayer (presumably the conveyance of the property in accordance with the contract)—although no performance seemed required prior to the time that the assigned installment in dispute came due. After the contract payments were assigned, a federal tax lien was filed against the assignor. The assigned payment in dispute did not fall due until after filing of the tax lien. In holding the assignment valid, the court indicated: "The fact that the property subject to the lien is a present right to receive money in futuro does not make the lien inchoate, at least where the right is unconditional."⁹³ Despite the court's language, the right to receive the money was at least conditional on the passage of time.⁹⁴

89. Memorandum for the United States, *supra* note 67, at 6 (emphasis added).

90. 368 U.S. 347 (1961).

91. *United States v. Crest Fin. Co.*, 302 F.2d 568, 569 (7th Cir. 1962) (*per curiam*). The court stated that "[w]e cannot change our position as readily as the Government has done in this case, and we adhere to the position hereinbefore taken."

92. 324 F.2d 101 (9th Cir. 1963).

93. *Id.* at 103.

94. While discussing the question of the identity of the property subject to the lien, note should be taken of the cases of *United States v. Ray Thomas Gravel Co.*, 373 S.W.2d 333 (Tex. Civ. App. 1963), *rev'd* on other grounds, 380 S.W.2d 576 (Tex. Sup. Ct. 1964), and *Davis & Warshow, Inc. v. Iser, Inc.*, 30 Misc. 2d 528, 220 N.Y.S.2d 818 (Sup. Ct. 1961). In the former case Seabreeze Pools entered into a contract with Paden on May 31, 1960 to build a swimming pool. On September 9, 1960 Seabreeze made an assignment of his contract

Some writers, distinguishing *Crest Finance*, have indicated that prior to the Federal Tax Lien Act of 1966 "the expected proceeds of an executory contract, which were yet to be earned by the taxpayer's performance, were regarded as not 'in existence,' and a security interest therein was deemed 'inchoate' and was subordinated to an intervening federal tax lien."⁹⁵ A careful review of the cases cited to support their view, however, finds that they do not seem to stand indisputably for that proposition.⁹⁶ Furthermore, even if the cases did hold what they are cited for, they could scarcely be regarded as conclusive in a field in which any pronouncement below the level of the Supreme Court has been vulnerable to re-

right to Turner. At the time the assignment was made about 1/3 of the work was completed. Prior to September 9, 1960 the federal government filed a notice of tax lien against Seabreeze. The federal government later filed notice of a second tax lien after September 9 with knowledge of the Turner assignment. The court held that the Turner assignment had priority over the second tax lien. The court declared that the lien created by the assignment was choate and perfected when Paden was notified of the assignment. Under Texas law the assignor's contract right was "property" although it was contingent on completion of the contract work.

In the latter case there was an assignment by a contractor to a materialman of money to become due to the contractor from the city pursuant to a contract. The federal government filed notice of a tax lien against the contractor subsequent to the materialman's notification to the city of the assignment from the contractor. The government argued that because at the time of the assignment the contract work had not been performed by the contractor and accepted by the city there was nothing which the contractor could assign, and so the assignment was of an inchoate interest. The government argued that the materialman's interest had to be specific and choate at the time of the assignment in order to operate as a transfer of legal title to the materialman and be superior to the federal tax lien. The court rejected the government's argument stating that the assignment was choate unless it could be shown that the parties did not intend a present and irrevocable transfer of the property interest. See generally Seligson, *Creditors' Rights*, 36 N.Y.U.L. Rev. 601 (1961).

95. W. Plumb & L. Wright, *supra* note 8, at 93; see Coogan, *supra* note 8, at 1386.

96. See, e.g., *Dean Constr. Co. v. Simonetta Concrete Constr. Corp.*, 65-1 U.S. Tax Cas. ¶ 9253 (S.D.N.Y. 1965) (The assignment in this case involved after acquired accounts receivable not existing contract rights.); *Jett Drilling Co. v. Tibbits*, 64-2 U.S. Tax Cas. ¶ 9540 (W.D. La. 1964) (Here the lien was held inchoate because the amounts assigned were indefinite. The court does not state that the proceeds to be derived under an executory contract are not in existence.); *In re Hudon & Son, Inc.*, 65-2 U.S. Tax Cas. ¶ 9517 (D. Mass. 1964) (The assignment in this case involved after acquired accounts receivable, not existing contract rights.); *Randall v. Colby*, 190 F. Supp. 319 (N.D. Iowa 1961) (The court merely held that the bank was not a mortgagee or pledgee. However, the decision is unclear.) The cases of *United States v. Chapman*, 281 F.2d 862 (10th Cir. 1960) and *First State Bank v. United States*, 166 F. Supp. 204 (D. Minn. 1958), were also distinguished from *Crest* by the Government in its memorandum. See Memorandum for the United States, *supra* note 67, at 7-8 n.2. Professor Coogan in his article, *supra* note 8, at 1386, states that under pre-Act law when a taxpayer performed a contract subsequent to tax lien filing, the right to future payments so earned were held not to be the taxpayer's property at the time of filing—but were after acquired collateral. However, no cases were cited for this proposition.

versal.⁹⁷ Only one of the cases went beyond the district court level,⁹⁸ and all seem understandably to reflect confusion as to the meaning of *United States v. R. F. Ball Construction Co.*,⁹⁹ which did not involve the question of whether the property subject to the mortgage was sufficiently specific to meet the choate lien test. The case cited by such writers, closest in point¹⁰⁰ decided that a bank was not a "mortgagee," "pledgee" or "purchaser" for purposes of Internal Revenue Code of 1954, section 6323 and, in passing, mentioned that "[t]he assignment had to do with monies that would become due in the future under an executory contract."¹⁰¹ It is not clear to what extent, if at all, the decision was influenced by the fact that future payments were involved. In any event, the quoted language describes the situation in *Hammes*¹⁰² which, as indicated earlier, ruled against the tax lien.

In addition, state law concerning secured transactions generally makes it clear that payments to come due under an existing lease, charter or other contract can serve as security for a loan and are not a species of after-acquired property. The leading case, decided by a distinguished court, is *Rockmore v. Lehman*.¹⁰³ In that case, Calvert was obligated under contracts to pay fixed sums over a period of years for the furnishing and maintenance of signs. The contracts were assigned as security for loans.

The advances were not made upon a mere agreement to assign rights which might arise in the future and did not exist at the time contracts were made, but upon assignments of definite contractual obligations.¹⁰⁴

We are convinced that the New York Court of Appeals has differentiated assignments of existing contracts by way of pledge from agreements to assign rights that have not yet come into being,¹⁰⁵ even as interests contingent upon counter-performance.¹⁰⁶

[W]e hold that the date of the assignments governed the imposition of the liens on any sums due from Calvert. *This is because the contracts, and not the moneys accruing under them, were the subjects of the assignments.*¹⁰⁷

97. The cases reversed are listed in Kennedy, *supra* note 87, at 729 n.23.

98. See cases cited note 96 *supra*.

99. 355 U.S. 587 (1958).

100. *Randall v. Colby*, 190 F. Supp. 319 (N.D. Iowa 1961).

101. *Id.* at 341.

102. 324 F.2d 101 (9th Cir. 1963).

103. 129 F.2d 892 (2d Cir. 1942), cert. denied, 317 U.S. 700 (1943). See also Restatement of Contracts § 149(5) (1932); Restatement of Security § 1a (1941); 4 A. Corbin, *supra* note 29, at § 881.

104. 129 F.2d at 892.

105. Many times this distinction was not made in the cases or by the commentators previously cited. See cases cited and text accompanying note 96 *supra*.

106. 129 F.2d at 892.

107. *Id.* at 893 (emphasis added).

Rockmore v. Lehman is exceptionally good authority because of the manner in which it arose. At the district court level the trustee in bankruptcy of the assignor unsuccessfully opposed the assignments.¹⁰⁸ On appeal to the second circuit, Judge Augustus Hand and Judge Frank initially reversed on the ground that the assignment of contract rights "constituted no more than promises to pay the assignees out of funds to be created by the assignor's labor which could not withstand the attack of the trustee in bankruptcy."¹⁰⁹ Judge Clark, dissenting in a well reasoned opinion, said:

I do not believe the decisions require so ancient a theory as that an assignment of definite contract rights, future only in the sense that they are conditioned upon the performance which the promisee has promised, is only a promise to pay out of future funds, and not a present transfer. The New York cases cited . . . are all distinguishable. *Some deal with after-acquired property; and some with future accounts receivable. Such cases emphasize the distinction between assignment of rights under an already existing contract and of rights to be created by promises in the future.*¹¹⁰

A motion for rehearing was made and Milbank, Tweed & Hope, Davis Polk Wardwell Gardiner & Reed, Larkin, Rathbone & Perry, Shearman & Sterling and White & Case, all of New York City, appeared as amici curiae on the brief. The rehearing was granted; the earlier decision was held erroneous and the decision of the district court was affirmed. *Certiorari* was denied by the Supreme Court.¹¹¹

The law firms at the rehearing demonstrated to the court that in a period of one week their clients had lent six hundred million dollars to contractors doing war work. Security for the loans was limited to an assignment of contract payments by the Government. These rights were all contingent on future performance by the assignors. They also pointed out that during the same week the bank lent over two billion dollars for which the assignment of contract rights was the chief security. The vital importance to the financial community of this type of security caused the court to reverse and approve Judge Clark's dissent.¹¹²

Today, it could undoubtedly be demonstrated that hundreds of billions of dollars have been invested on the security of future payments coming due under existing leases, charters and other contracts. While in many instances the lender may also have a mortgage on real or personal property, this will not always be true.¹¹³ For the courts to conclude that such

108. See *Rockmore v. Lehman*, 128 F.2d 564, rev'd on rehearing, 129 F.2d 892 (2d Cir. 1942), cert. denied, 317 U.S. 700 (1943).

109. 128 F.2d at 567.

110. *Id.* (dissenting opinion) (emphasis added).

111. 129 F.2d 892 (2d Cir. 1942), cert. denied, 317 U.S. 700 (1943).

112. See 4 A. Corbin, *supra* note 29, at § 903 (Supp. 1964).

113. Many times "corporate real estate obligations" are secured merely by an assignment

security interests are "inchoate" could cause disaster in the financial community.

Prior to passage of the Tax Lien Act, then Assistant Chief Counsel Reiling of the Internal Revenue Service, while necessarily speaking in a personal rather than an official capacity, made the following observations concerning those writers who had suggested that an assignment of the kind being considered would be "inchoate":

What also is disturbing, in current criticism, is the doubt that some attempt to cast upon the priority of pledges or assignments of future wages and rents made prior to the assertion of a tax lien. The doubt, so it is alleged, arises because of the decision of the Supreme Court in the *R. F. Ball Construction Company* case; but I do not agree that the decision in that case poses any such doubt.

When the tax lien arises, if, as was true in the Ball Construction case, there is no debt or obligation to be secured by the pledge, obviously the nominal pledgee then has no property right in the future income covered by the pledge instrument. That was generally recognized long before this Supreme Court decision, for a pledge without a debt or obligation to be secured by it really is not pledge. On the other hand, if the pledge is made as security for an obligation which is definite at the time the tax lien arises, the pledgee may easily show the extent of his interest in the future income.

In my opinion, the priority of the pledge is not affected by the fact that future income is pledged, for future income may be fully assigned if the assignment is for consideration, and it follows that an interest in such income may be assigned as security for the satisfaction of a debt or obligation.¹¹⁴

The same conclusion with respect to assignments of rents was reached by Clark C. Havighurst.¹¹⁵

Furthermore, it appears that analytically the choate lien doctrine does not require a different result. The Court has indicated that the property subject to the competing lien must be specific as of the date of tax lien filing.¹¹⁶ The property subject to the competing lien is the taxpayer's interest in the assigned lease, charter or contract. That interest is *in esse* at the time of the assignment. Part of that interest is the right to receive future payments. That too, is a specific, existing right which is recognized universally as a proper subject for a security interest.¹¹⁷ In the types of transactions being considered, lenders advance substantial sums in reliance on the effectiveness of such security interests. For the Court to insist that the money involved must have been actually earned by the taxpayer's performance or must have been unconditionally payable as of

of leases, and mortgages are not used as an additional form of security. See Letter from Insurance Department to All Insurers Authorized to do Business in the State of New York, Nov. 27, 1961, on file in New York State Insurance Department.

114. Reiling, Priority of Federal Tax Liens, 36 Taxes 978, 983 (1958) (footnotes omitted).

115. Havighurst, *supra* note 8.

116. See *United States v. City of New Britain*, 347 U.S. 81 (1954).

117. See 4 A. Corbin, *supra* note 29, at § 903 (1964 Supp.).

the time of federal tax lien filing would be to add another, unnecessary dimension to the choate lien doctrine. Such an addition would seem particularly inappropriate in light of congressional efforts in the 1966 Act to harmonize tax lien law with modern financial practices. If, in a particular case, the factual situation would result in an abuse,¹¹⁸ the Court can treat that specially. To fashion a broad rule, however, which would invalidate or cast doubt on a widespread, desirable, and highly important financing technique would be completely impractical and a tremendous disservice to the financial community. Legislative relief with retroactive effect would become imperative.

Again turning to some of the variations mentioned earlier,¹¹⁹ an assignment should be valid as against the later federal tax lien whether it is an assignment of an existing lease, charter or contract or of payments due thereunder. As suggested above,¹²⁰ if the contract is *in esse*, the right to future payments is also *in esse*,¹²¹ and this right may be effectively transferred outright or as security.¹²² The fact that actual payment may be conditional on some performance does not alter the fact that the right to payment is specific, existing, intangible personal property,¹²³ and that a valid security interest can be created therein. Likewise, the other variations mentioned¹²⁴ should not alter the result if a valid security interest has been created under applicable local law prior to tax lien filing.

It is concluded, therefore, that before passage of the Federal Tax Lien Act of 1966, there had been no clear holding that an assignment for security of an existing lease, charter or contract or payments due thereunder was inchoate merely because some payments, not yet earned by

118. An assignment of contract rights under certain circumstances might not protect the creditor's position as well as it might be thought. See 2 G. Gilmore, *supra* note 3, at §§ 41.1-41.11 for a detailed description of the risks confronted by an assignee of contract rights. However, the assignments discussed in this article assume that the assignee has taken certain measures to protect his interest in the assigned contracts. For instance, many times the lender requires that the borrower make covenants besides the repayment agreement. The most common one is that the borrower and high credit corporation agree not to amend or terminate the lease or contract without the prior approval of the lender. The high credit corporation might also agree to waive certain possible defenses so as to assure the lender of repayment of the loan. Gustin, *supra* note 1, at 689-90, 695.

119. See text accompanying note 5 *supra*.

120. See text accompanying note 117 *supra*.

121. *Id.*

122. *Id.*

123. See *Torkington v. Magee*, [1902] 2 K.B. 427, 430 where the court said that a "[c]hose in action' [contract right] is a known legal expression used to describe all personal rights of property which can only be claimed or enforced by action. . . ."; *Restatement of Property*, Introductory Note ch. 1 (1936).

124. See text accompanying note 5 *supra*.

performance or unconditionally payable, fell due after filing of a federal tax lien. Furthermore, because such property or rights to property assigned for security are *in esse*, they are "specifically identified"¹²⁵ for purposes of the choate lien test. Finally, the fact that future payments under an existing contract are not a species of after-acquired property should conclusively settle the matter unless the Federal Tax Lien Act of 1966, to which we now turn, requires a different result.

V. "IN ESSE" THEORY—POST FEDERAL TAX LIEN ACT

Prior to the Federal Tax Lien Act of 1966, the Internal Revenue Code contained virtually no provisions concerning the characteristics required of competing liens.¹²⁶ Until the choate lien doctrine was fashioned, it was generally assumed that competing liens would be recognized to the same extent as under state law.¹²⁷ As the doctrine grew and prospered, however, the necessity for comprehensive legislative reform became clear.¹²⁸

The general coverage of the new Act has been described elsewhere, and repetition here is not necessary.¹²⁹ Unfortunately, the particular problem under consideration was not made the subject of a special provision. However, the general provisions of the Act, together with the legislative history, afford a reasonably clear picture of congressional intent.

First, it is clear that the Act was not intended to affect the "threshold" requirement that the property subject to the federal tax lien belong to the taxpayer.¹³⁰ Therefore, the analysis previously made with respect to the property assigned in our assumed factual situation¹³¹ not being "property" of the taxpayer is still applicable under the new law.¹³²

If for any reason payments due under an existing lease, charter or other contract assigned as security are held to be property of the assignor-taxpayer to which a federal lien will attach, the starting point in determining the relative priority of the assignment as against a subsequent federal tax lien is Internal Revenue Code of 1954, section 6323 (a).¹³³ That

125. See Memorandum for the United States, *supra* note 67, at 6.

126. See, e.g., Int. Rev. Code of 1954, § 6323, as amended, Int. Rev. Code of 1954, § 6323 (1966).

127. See ABA Final Report of the Comm. on Federal Liens (1959).

128. *Id.*

129. E.g., Creedon, *The Federal Tax Lien Act of 1966—An Historic Breakthrough*, 4 *Harv. J. Legis.* 163 (1967); Plumb, *The New Federal Tax Lien Law*, 22 *Bus. Law.* 271 (1967).

130. See Int. Rev. Code of 1954, § 6321.

131. See text accompanying note 5 *supra*.

132. See text accompanying notes 28-72 *supra*.

133. "(a) Purchases [purchasers], Holders of Security Interests, Mechanic's Lienors, and Judgment Lien Creditors.—The lien imposed by section 6321 shall not be valid as against any purchaser, holder of a security interest, mechanic's lienor, or judgment lien creditor

subsection makes it clear that the "holder of [a] security interest" is entitled to priority over a subsequently filed federal tax lien against the taxpayer.¹³⁴ The key to the resolution of the problem, however, is the definition of security interest, which appears in paragraph 1 of subsection (h):

Definitions.—For purposes of this section and section 6324—

(1) Security interest.—The term "security interest" means any interest in property acquired by contract for the purpose of securing payment or performance of an obligation or indemnifying against loss or liability. A security interest exists at any time (A) if, at such time, the property is in existence and the interest has become protected under local law against a subsequent judgment lien arising out of an unsecured obligation, and (B) to the extent that, at such time, the holder has parted with money or money's worth.¹³⁵

The first element of the definition requiring consideration is the phrase "any interest in property." These all-inclusive words¹³⁶ undoubtedly include the interest of a taxpayer in a lease, charter or contract and payments to come due thereunder. It is, of course, necessary to distinguish between a contract which does not necessarily create a property interest in the subject matter of the contract and a contract which is itself intangible personal property. Rights under an existing executory contract are clearly assignable as security for a loan.¹³⁷ Therefore, the assignment in our assumed facts¹³⁸ constitutes a "security interest" under Code section 6323(h)(1).

For our security interest to prevail over a subsequent federal tax lien, it must "exist" within the meaning of subsection (h)(1) at the time notice of the tax lien is filed.¹³⁹ This leads to the next and most critical element of the definition. The security interest "exists" at the time "the property is in existence." What do these words mean and how do they apply to an assignment for security?

While the words "property is in existence" are used, obviously their literal meaning could not have been intended. For example, in the case of unimproved land, the property has presumably been "in existence" since

until notice thereof which meets the requirements of subsection (f) has been filed by the Secretary or his delegate."

134. A literal reading of the section might lead one to believe that the tax lien acquires validity as against the enumerated category of persons having earlier interests or liens once it is properly filed. But the literal reading does not reflect the intent as evidenced by *United States v. City of New Britain*, 347 U.S. 81 (1954), and by the committee reports. See H.R. Rep. No. 1884, *supra* note 75, at 3, 35.

135. Int. Rev. Code of 1954, § 6323(h)(1).

136. Black's Law Dictionary 950 (4th ed. 1951).

137. 4 A. Corbin, *supra* note 29, at § 874.

138. See text accompanying note 5 *supra*.

139. Int. Rev. Code of 1954, § 6323(h)(1).

our planet was formed. The purpose of the language was obviously to exclude "after acquired property" until it had in fact been acquired. Thus, if a security interest purported to cover all contract rights and accounts receivable "now owned or hereafter acquired by a debtor," a security interest would exist under section 6323(h)(1) in those contract rights and accounts receivable then owned by the debtor but no security would exist in those to be acquired in the future until they were in fact acquired. As was made abundantly clear in *Rockmore v. Lehman*,¹⁴⁰ the assignment of rights under an existing contract is not an assignment of after acquired property. The rights are presently existing and can be presently transferred and encumbered.¹⁴¹ That a security interest exists in these rights from the time they are assigned would seem to be beyond dispute. It should not be necessary to determine that a security interest also exists in the payments themselves that are to fall due after tax lien filing. These payments are incidents of the assigned lease, charter, contract or right and necessarily follow the instrument or right to which they relate.¹⁴² However, there is good authority for the proposition that a security interest should be recognized as existing even in the payments themselves.¹⁴³

There is supporting legislative history, if any is needed, for the interpretation just urged. For example, it is clear from more than one source¹⁴⁴ that contract rights are a species of property envisioned as being a proper subject of a security interest under the Act. While the specific discussion of contract rights in the legislative history relates to subsection (c) of section 6323,¹⁴⁵ it should be stressed that the recognition of security interests in contract rights as qualifying for the "superpriority" provided by subsection (c) necessarily involves recognition that they qualify for the normal priority of subsections (a) and (h)(1). Contract rights, by definition under the U.C.C., are rights to payment under a contract "not yet earned by performance."¹⁴⁶ Thus, Congress necessarily embraced the

140. 129 F.2d 892 (2d Cir. 1942), cert. denied, 317 U.S. 700 (1943).

141. 4 A. Corbin, *supra* note 29, at § 903 (Supp. 1964).

142. 6 C.J.S. Assignments § 85 (1937). Under the Uniform Commercial Code, the payments from security interests in personal property are characterized as "proceeds," which is "whatever is received when collateral or proceeds is sold." Uniform Commercial Code § 9-306.

143. See Coogan, *supra* note 3, at 1385.

144. H.R. Rep. No. 1884, *supra* note 75, at 42; Statement by Hon. Stanley S. Surrey, Assistant Secretary of the Treasury, Hearings on H.R. 11256 and H.R. 11290 Before the House Comm. on Ways and Means, 89th Cong., 2d Sess. at 38 (1966).

145. The sub-section provides in general that even though notice of a lien imposed by § 6321 has been properly filed the lien will be invalid as against enumerated types of security interests which come into existence within 45 days after tax lien filing.

146. Uniform Commercial Code § 9-106.

concept that rights to payments not yet earned by performance arising under existing assigned contracts are *in esse* and such a security interest will prevail over a later federal tax lien. Any other interpretation would necessarily involve a rejection of the idea that contract rights are a proper subject for a security interest because, if the payment under the contract had to be unconditionally payable or earned by performance, we would no longer be dealing with contract rights. It might be argued that contract rights can be valid security only under section 6323(c)(2)(C) if payment under the contract becomes payable within 45 days of tax lien filing. However, this argument basically rejects contract rights as a species of property in which a security interest can "exist," because once a payment has been earned, it is an account payable.

The Assistant Secretary of the Treasury, Stanley S. Surrey, under whose jurisdiction much of the drafting of the legislation took place, specifically indicated in his testimony before the House Ways and Means Committee that contract rights were an envisioned kind of security.¹⁴⁷ He also mentioned that chattel paper, notes, instruments and mortgages were envisioned subjects of security. Some of these are specifically mentioned in part of the Act.¹⁴⁸ Chattel paper as defined in the U.C.C. includes "a lease of specific goods."¹⁴⁹ All of the species of property mentioned necessarily involve payments coming due in futuro. In some of them, the amount of the payments will be fixed and unconditional. In others, such as a chattel paper involving a lease of specific goods, the payments will be conditioned on performance. Here then is further evidence of legislative intent.

The technical explanation of the Act contained in the Report of the Committee on Ways and Means reads in part as follows:

Commercial financing security defined.—Subparagraph (C) of section 6323(c)(2) provides that, for purposes of section 6323(c), the term "commercial financing security" means (i) paper of a kind ordinarily arising in commercial transactions, (ii) accounts receivable, (iii) mortgages on real property, and (iv) inventory. *In general, paper of a kind ordinarily arising in commercial transactions includes any written document customarily used in commercial transactions. For example, the term includes paper giving contract rights (as defined in art. 9-106 of the Uniform Commercial Code); chattel paper (as defined in art. 9-105(b) of the Uniform Commercial Code); documents (as defined in art. 9-105(e) of the Uniform Commercial Code), such as documents of title to personal property; and, instruments (as defined in art. 9-105(g) of the Uniform Commercial Code), such as negotiable instruments or securities. It does not include general intangibles (for example, patents or copyrights), as such intangibles are defined in article 9-106 of the Uniform Commercial Code. Inventory which is commercial financing security includes raw materials and goods in*

147. Surrey, *supra* note 144, at 38.

148. Int. Rev. Code of 1954, § 6323(c)(2)(C).

149. Uniform Commercial Code § 9-105(1)(b).

process as well as property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.¹⁵⁰

Several important observations should be made about this explanation. Note how carefully certain definitions are spelled out in detail, while others are made by reference to the U.C.C. Particular attention to the scheme followed is required of U.C.C. experts who may otherwise tend to assume that the Act was intended to conform to the U.C.C. to a greater degree than is the fact. For example, the familiar term "security interest" which to the U.C.C. expert means an interest in personal property, under the Act embraces an interest in *any* property. Similarly, the words quoted above "paper of a kind ordinarily arising in commercial transactions" may have a certain meaning in the typical U.C.C. context. The Committee on Ways and Means, however, (in a paragraph in which it otherwise incorporates U.C.C. definitions) very clearly and purposefully defined "paper of a kind ordinarily arising in commercial transactions" to include *any written document* customarily used in commercial transactions. Moreover, the Committee then enumerated certain kinds of paper, including contract rights, that were included and certain kinds (general intangibles) that were excluded. Again, the Committee quite carefully defined "contract rights" by reference to the U.C.C., which are rights "unearned by performance." It did the same with "chattel paper."

Thus, the Act obviously recognizes as property that may be the subject of a security interest various kinds of property involving future payments, unearned by performance. It is perhaps worth repeating that this recognition, while appearing specifically in connection with the relatively narrow term "commercial financing security" in section 6323(c)(2)(C), necessarily carries over to section 6323(h)(1), where the broader term "any interest in property" obviously must include any interest in specific kinds of property embraced within the narrower definition of "commercial financing security."

As suggested earlier, the fact that the Act contemplates security interests in property of a kind that necessarily involves payments in the future strongly supports the interpretation urged above that such property is "in existence" and that a security interest "exists" even though payments under the assigned lease, charter or contract fall due after tax lien filing. It would seem very unrealistic to interpret the Act to require that future payments coming due under some or all property, such as contract rights, chattel paper, including leases of personal property, mortgages, notes, leases of real property and other long-recognized similar forms of security, would only be valid security if the payments became

150. H.R. Rep. No. 1884, *supra* note 75, at 42 (emphasis added).

payable within 45 days after tax lien filing—especially in situations (such as our assumed factual situation) in which advances are not made periodically. Such an interpretation would, for all practical purposes, nullify such security as against later federal tax liens.

Some writers have suggested that future payments under a lease of tangible personal property might be treated differently under the Act from future payments under a lease of real property because only the former are mentioned in the House Report.¹⁵¹ Again, it must be realized that the personal property leases are mentioned solely in connection with the subsection (c)(2)(C) definition of "commercial financing security" which deals primarily with an exception to the requirement in subsection (h)(1) that "the holder has parted with money" as of the date of tax lien filing. It would seem illogical to reason that because leases of chattels are valid security under subsection (c)(2)(C), that is an indication that future payments under such leases are valid under subsection (h)(1) but that future payments under other instruments are not valid. It can be reasoned more persuasively that the fact that future payments are recognized under subsection (c)(2)(C) is an indication that the "property in existence" requirement of subsection (h)(1) is met in the case of a security interest in an existing lease, charter or contract involving future payments.

Suppose, for example, there were no subsection (c)(2)(C). Assume further that the House Report otherwise reflected an interest in expanding the classes protected under section 6323(a) to include the usual kinds of U.C.C. interests. The phrase "any interest in property" would suffice for such purpose. Clearly "chattel paper" is an interest in property. Clearly it involves future payments. If there were any intent to exclude future payments, would not some express language for that purpose have been included in subsection (h)(1)? No such language was included. The requirement that the property be "in existence" is not adequate because the chattel paper is "in existence." Furthermore, because of the nature of U.C.C. financing, Congress concluded that certain types of U.C.C. transactions should be protected even as against *earlier* federal tax liens. This protection was limited to situations in which the loan was made or the security interest in the property was acquired within 45 days *after* tax lien filing.¹⁵² In addition, the protection was limited to security interests in only certain kinds of property, not simply any interest in property. Here, it was necessary to mention the kinds of property entitled to this "superpriority." Chattel paper, contract rights and other property involving future payments are clearly intended to be protected. Would

151. W. Plumb & L. Wright, *supra* note 8, at 95.

152. Int. Rev. Code of 1954, § 6323(c)(2).

Congress be giving these interests a "superpriority" if they were not already protected under subsection (h)(1) for a normal priority? Clearly not. Thus, the conclusion is inescapable that subsection (h)(1) has no requirement that would prevent leases, charters and contracts involving future payments from constituting valid, existing security. Mr. Surrey, referring to the 45 day "superpriority," recognized that chattel paper, contract rights, and other forms of commercial financing security involving future payments would be entitled to first in time, first in right priority when he stated: "If notice [of the tax lien] has not been filed [when the loan is made] they will, of course, be protected as security interests against the unfiled Federal lien."¹⁵³

Finally, it is appropriate to examine to what extent the Federal Tax Lien Act was intended to supersede the "choate" lien doctrine as far as assignments for security are concerned. As mentioned earlier,¹⁵⁴ the House Report states:

Under decisions of the Supreme Court a mortgagee, pledgee, or judgment creditor is protected at the time notice of the tax lien is filed if the identity of the lienor, the property subject to the lien, and the amount of the lien are all established at such time. . . . Except as otherwise provided, subsection (a) of new section 6323 retains this basic rule of Federal law.¹⁵⁵

The major inquiry, then, is to what extent does the Act "otherwise provide." It is submitted that as far as security interests are concerned the Act was intended to supersede completely the choate lien doctrine. For ten years, groups of lawyers worked on developing a set of specific provisions relating to security interests that would override the choate lien doctrine—carefully balancing the interests of the federal government and private creditors. This is not to say that many of the elements of the choate lien doctrine were not written into the Act so as to protect the federal lien. It is to say, however, that the Act was drafted in response to the Supreme Court's invitation to legislate in the field and that the statute, and not the long line of cases that the statute was intended to replace, is now the sole arbiter of the relative priority of federal liens and security interests.

If this is true, then what is the meaning of the phrase quoted from the House Report? To some extent nonstatutory case law may continue to govern the "judgment lien creditor" mentioned in section 6323(c). The choate lien doctrine will also presumably continue to apply to garnishments, attachments, landlords' liens, state and local liens of some kinds and other statutory liens. While these interests are not mentioned in

153. Surrey, *supra* note 144, at 38.

154. See text accompanying note 76 *supra*.

155. H.R. Rep. No. 1884, *supra* note 75, at 35 (citation omitted).

section 6323(a), the intent is clear that the choate lien doctrine continues to govern them. But as to purchasers and security interests the detailed provisions of section 6323 are necessarily intended to control.

Thus, in determining the question under consideration, the governing provision is subsection (h)(1) and its definition of security interest. Nothing in that subsection suggests that a security interest in an existing lease, charter or contract involving future payments is not a valid security interest as against a later federal tax lien. Rather as suggested above, the evidence is all the other way.

Unfortunately, the first case under the Act involving one aspect of this problem failed to analyze the question along the lines suggested. In *Continental Finance, Inc. v. Cambridge Lee Metal Co.*,¹⁵⁶ Centre, a trucking firm, entered into a security agreement with Continental Finance on December 19, 1962, under which Centre assigned certain property to Continental as security for loans to be made. Continental made the loans pursuant to such agreement prior to tax lien filing against Centre on February 10, 1964. A dispute arose between Continental and the United States with respect to their relative priority to money owing by Cambridge Lee Metal Company under a contract dated October 17, 1962 between Cambridge and Centre. The parties stipulated in the action that prior to the tax lien filing on February 10, 1964, Continental had a perfected security interest in Centre's contract rights under the executory contract with Cambridge. After tax lien filing, Centre performed work for Cambridge which caused Cambridge to owe \$10,812 under the contract, an amount less than the amount owing by Centre to Continental as of the date of tax lien filing.

In its brief the Government's argument was based completely on the statutory provisions prior to the 1966 Act.¹⁵⁷ Presumably, it was prepared and submitted before the 1966 Act was passed. The decision was handed down, however, on April 5, 1968, and reflected an awareness of the new Act.¹⁵⁸ After setting forth in full certain relevant portions of new section 6323, instead of analyzing the new provisions to determine whether or not contract rights were intended to be a proper subject for a security interest under the Act, the court went off on what seems to be a pre-1966 tangent, saying:

156. 100 N.J. Super. 327, 241 A.2d 853 (L. Div. 1968).

157. Brief for Government at 6-9, *Continental Fin., Inc. v. Cambridge Lee Metal Co.*, 100 N.J. Super. 327, 241 A.2d 853 (L. Div. 1968). A copy of the government's brief was obtained by the author through the attorneys for Continental Finance.

158. See *Continental Fin., Inc. v. Cambridge Lee Metal Co.*, 100 N.J. Super. 327, 332-34, 241 A.2d 853, 855-57 (L. Div. 1968).

[B]efore the rule [first in time, first in right] is applied the state created lien must be specific and perfected in the federal sense. . . .

. . . A competing state-created lien has no protection against a recorded Federal Tax Lien until it becomes choate in the federal sense.¹⁵⁹

The court then returned to analyze section 6323(c), which was not applicable because the loan by Continental to Centre was made and the contract rights were assigned prior to tax lien filing. If Continental was entitled to priority over the federal tax lien, it would have been entitled on the facts to priority under section 6323(a) and subsection (h)(1) not section 6323(c). In any event, the court again returned to the choate lien doctrine, and the three way specificity requirement of identity of the lien or, amount of the lien, and property subject to the lien.¹⁶⁰ It concluded, because the proceeds of the assigned contract were earned after the date of tax lien filing, the lien was inchoate.

Next the court emphasized that the 1966 Act reaffirmed the choate lien test because it requires that property be "in existence" at the time of tax lien filing. It rejected the argument that the contract rights rather than the proceeds were the security and that the contract rights were in existence and assigned long before tax lien filing. Again, its reasoning was that the lien was not "choate," citing a host of pre-1966 Act cases.

What the court has concluded is that contract rights cannot be the subject of an effective security interest under present law. To require that the payment be earned at the time of tax lien filing is to require that the security interest exist in an account receivable. The court's conclusion is reached in the face of extensive evidence in the legislative history of the 1966 Act that the Act was intended to bring tax lien law closer in line with commercial practices.¹⁶¹ While it is perhaps possible (though in the writer's opinion incorrect) to reach this conclusion on the particular facts of *Continental Finance* (because contract payments did not have to be paid over to the lender, and no fixed payments were called for), such conclusion should be reached on the basis of an analysis of section 6323(a) and subsection (h)(1) and its legislative history and not on the basis of the now time-worn choate lien doctrine.

Admittedly, after more than fifteen years of having to contend with the choate lien doctrine, it is not easy to abandon it and contend solely with interpretation of the 1966 Act. And the court may have relied on the general statement of the House Report¹⁶² that "except as otherwise

159. Id. at 335-36, 241 A.2d at 857-58 (citing pre-1966 cases).

160. See *United States v. City of New Britain*, 347 U.S. 81, 84 (1954).

161. See generally House Comm. on Ways and Means, 89th Cong., 2d Sess., Legislative History of H.R. 11256, Federal Tax Lien Act of 1966.

162. See text accompanying note 155 supra.

provided" the three-way test of the choate lien doctrine continues to apply under section 6323(a). As suggested, however, it is otherwise provided as to "security interests."

The court in *Continental Finance*¹⁶³ distinguished *In re Halprin*¹⁶⁴ on the ground that in *Halprin*, the account debtor had agreed to pay the finance company directly, whereas in *Continental* no such agreement was made. While such a distinction is possible, a contrary result would be supported by *Bess*, *Aquilino*, *Durham Lumber* and the *no property* doctrine.¹⁶⁵

In summary, it is believed that future payments under an existing lease, charter or contract effectively assigned as security prior to tax lien filing can and should be regarded under present law as not being "property" of the assignor-taxpayer to which a tax lien against him will attach. If for some reason it does attach, an earlier security interest should be regarded as existing in property *in esse* and thus should be entitled to priority over a later federal tax lien.¹⁶⁶

VI. PURCHASE MONEY PRIORITY

In the facts assumed thus far, the loan by *L* was fully advanced prior to the time notice of a tax lien was filed against *B*.¹⁶⁷ In some circumstances, however, it is possible that part or all of *L*'s advances will have been made after the date of tax lien filing. Subsections (c) and (d) of section 6323 afford limited protection to *L* as to future advances if the security interest meets the tests set forth therein.¹⁶⁸ Even if *L* is not so protected, he may find protection under the umbrella of the purchase money priority doctrine.¹⁶⁹ The U.C.C. affords special recognition to various kinds of purchase money interests.¹⁷⁰

The Report of the Committee on Ways and Means on the 1966 Act recognizes the fairness of the purchase money doctrine and affirmatively indicates that the Act is not intended to affect its traditional applica-

163. 100 N.J. Super. at 338, 241 A.2d at 859.

164. 280 F.2d 407 (3d Cir. 1960).

165. See text accompanying notes 28-72 *supra*.

166. It should be noted that under our assumed facts, see text accompanying note 5 *supra*, the entire loan was made prior to tax lien filing. The 1966 Act does provide in § 6323(c)(d) for limited protection in the case of advances made after tax lien filing.

167. See text accompanying note 5 *supra*.

168. See Int. Rev. Code of 1954, § 6323(c)(d). For a discussion of this section see Coogan, *supra* note 8, at 1394-1412; Creedon, *Impact on Life Companies of the Federal Tax Lien Act of 1966*, at 29-39 (Paper presented to The Association of Life Insurance Counsel, May 8, 1967); W. Plumb & L. Wright, *supra* note 8, at 69-110.

169. See 2 G. Gilmore, *supra* note 3, at §§ 28.1-29.5.

170. Uniform Commercial Code §§ 9-107, 9-312.

tion.¹⁷¹ Since passage of the Act, the Internal Revenue Service has issued a ruling affirming an intention to recognize the doctrine in enforcing and asserting federal tax liens.¹⁷²

The scope of the purchase money doctrine has never been completely clear. A liberal approach to its application offers the enforcement and judicial authorities an opportunity to favor competing creditors in circumstances in which loans from the creditors prime the pump that produces the flow of funds under the lease, charter or contract. As indicated earlier, in many situations, the loan from *L* is used to build the building or the ship or the pipeline or the other property which gives rise to the rents or payments assigned.¹⁷³ In such cases, it will frequently be equitable to permit recovery of the loan prior to assertion of the federal tax lien. Congressional recognition of the purchase money doctrine evidences a willingness to have it applied so as to afford relief from the relatively onerous requirements otherwise applicable under federal law to competing liens.

Illustrative of how a benevolent court can take a broad view of the purchase money doctrine is the case of *In re Halprin*.¹⁷⁴ There, Commercial made advances to taxpayer Halprin after notice of the tax lien was filed. The advances were made to supply Halprin with funds "to meet current payrolls."¹⁷⁵ In holding an assignment for security to be entitled to priority over an *earlier* filed federal tax lien, the court said:

It is fair that this distinction [that contract payments were not property of the taxpayer] be utilized to protect persons in the position of Commercial here. It is eminently appropriate that one who finances property-producing transactions be able to look for security to the acquisitions he is making possible. This justifies the common law rule enabling a purchase-money mortgagee, even one with notice, to prevail over the holder of a prior security interest claiming under an after-acquired property clause. . . . The financing of the performance of a manufacturing contract such as we have here is a transaction essentially similar to a purchase-money mortgage; in a real sense, the debt now owed by Doniger was created by funds furnished by Commercial. . . .

From a somewhat different approach, such a lender as Commercial has enriched the taxpayer's estate by the amount loaned to the taxpayer. For this reason, it is not unreasonable to allow it a corresponding security interest in the fruit of the borrowed money, with the government relegated to the borrowing taxpayer's net after the lender is reimbursed. The government has suffered no diminution of the assets which were available to satisfy its tax claim before the loan. In addition, if the tax collector should seize the borrowed funds before their expenditure he could do so.¹⁷⁶

171. H.R. Rep. No. 1884, supra note 75, at 4.

172. Rev. Rul. 68-57, 1968-1 Cum. Bull. 553.

173. See text accompanying note 1 supra.

174. 280 F.2d 407 (3d Cir. 1960).

175. Id. at 408.

176. Id. at 410.

Similar views by other courts would go far toward eliminating the bitter taste remaining from the strict and sometimes blind application of the choate lien doctrine.

VII. CONCLUSION

Of course, the best way to avoid problems with federal tax liens is to make loans only to borrowers who pay all their federal taxes. To the extent feasible, therefore, lenders will often be advised to try to structure their transactions so there is reasonable assurance that the borrower's federal taxes will be paid.¹⁷⁷

Similarly, to the extent practicable, lenders may arrange transactions so as to make them least vulnerable to possible attack by later federal tax liens.¹⁷⁸ In the final analysis, however, the burden is now on the courts to implement the spirit and intent of the Tax Lien Act of 1966 to bring federal tax lien law closer in line with financial practice. In the words of one court:

[A] federal tax lien tends to defeat its ultimate purpose if it impedes the effective assignment of future earnings as security for funds needed to make such earnings possible. The result of such extension of the tax collector's reach is likely to be the destruction of the earning power, and with it the taxpaying power of the burdened business.¹⁷⁹

177. Preferably the high credit corporation should be obliged to pay the borrower's taxes as additional rent or in the form of a contract payment. However, such assurances cannot always be obtained. If the borrower possesses no assets or income save the rental or contract payments owing from the high credit corporation, the immediate threat of a tax lien is minimal because the borrower's income from rents or the contract would, for the most part, be offset at the beginning by its deductions for interest and accelerated depreciation allowances. Moreover, this type of financing greatly relies upon the allowance for depreciation because such benefit provides the borrower with the tax-free funds which enable it to repay the loan. See Gustin, *supra* note 1, at 698.

178. See Havighurst, *supra* note 8, at 953.

179. *In re Halprin*, 280 F.2d at 410 (3d Cir. 1960).