RELATIVE PRIORITY OF FEDERAL TAX LIENS AND ASSIGNMENTS OF RENTS IN LEASE FINANCINGS

By

CLARK C. HAVIGHURST*

New York City

In most lease financings, a present assignment of the rents to become due under the lease is the primary security of the lender.[1] Frequently, a mortgage of the leased chattels or real estate is also given, but the assignment of rents is the device which permits the lender to rely primarily upon the lessee's credit in making the loan to the lessor. The importance of the assignment of rents as security requires that it be fully enforceable against both the lessee and the lessor under all circumstances. By insisting that the lease be a "net" lease, under which the lessee undertakes all responsibilities with respect to the leased property, the lender can assure that no default by the lessor will terminate the rental payments. Furthermore, the assignment of rents will generally be superior to any intervening liens belonging to creditors of the lessor. However, developments in recent years in the law relating to the priority of federal tax liens have indicated a distinct possibility that the federal government might succeed in asserting its claim for the lessor's unpaid taxes against the rental payments due under the lease.[2]

A typical lease financing normally involves the creation of a single-purpose corporation to act as lessor. This corporation purchases the property to be leased, either from the prospective lessee or from a third party, and finances the purchase by borrowing the purchase price from institutional lenders, giving as security an assignment of the rents payable under the lease and perhaps a mortgage. The rent assignment usually includes all other sums payable under the lease, including amounts paid as additional rent for the reimbursement of

*Member of the New York and Illinois Bars.

1. While this article is concerned solely with assignments of rents, the discussion would be equally applicable to an assignment of the lease under which the rents are payable. Such an assignment would, of course, include the rents and might conceivably be treated with greater respect than a rent assignment in some jurisdictions. Because a lease is often treated as tangible property in its own right, it might be easier to create a "choate" and "perfected" lien on it than on the rents alone. Moreover, an assignment of the lease might be more likely to be regarded as a mortgage or pledge for purposes of applying Int. Rev. Code of 1954 § 6323(a).

2. Rev. Stat. § 3466, 31 U. S. C. § 191, deals with the priority of claims of the federal government against the assets of an insolvent debtor. This article does not deal with this statute, but the doctrines discussed herein were originally drawn from the case law under it. United States v. City of New Britain, 347 U. S. 81 (1954). This suggests that no creditor who is able to compete for priority with a federal tax lien arising under Int. Rev. Code of 1954 § 6321 will have difficulty in achieving priority over any claim by the government under Rev. Stat. § 3466.

any expenses of the lessor or assignee. The lessee is required to consent to the assignment and to agree to make all rent and other payments under the lease to or as directed by the assignee. The rents under the lease are set at a level determined by what is required to amortize the principal and interest payable on the loan and are applied by the assignee immediately upon receipt to the payment of the note installment then due. Any excess over the amount then owing is paid over to the lessor. Numerous variations on these arrangements are possible.

Where the lessor is a corporate shell having no assets other than the leased property and no income other than the assigned rental payments, the immediate danger of a tax lien is reduced since the corporation's rental income would be largely offset in the early years by its interest and depreciation deductions. As the interest payments decline and depreciation deductions taken at an accelerated rate decrease, the lessor's tax liability will become substantial and the possibility of a tax lien will be increased. As a practical matter, some arrangement is always made for meeting this tax liability. Failure to make such an arrangement would lessen the protection afforded by the assignment of rents since the Internal Revenue Service would have grounds for attacking the legitimacy of the transaction if the lessor, which could anticipate a substantial tax liability, were made effectively judgment-proof.

Sometimes the lessor will be an active corporation, perhaps engaged in equipment leasing. In other cases it is contemplated that the lessor will transfer its interest, subject to the lease, the assignment, and a mortgage, to an individual having substantial taxable income in order to permit the individual to have the benefit of accelerated depreciation deductions against his other income.[3] In either situation, there is increased exposure to income tax liabilities likely to result in the assertion of a tax lien against the rental payments. The exposure would be further increased in the latter situation mentioned if the Revenue Service should someday challenge the right of such an individual, whose investment in the property is often nominal, to claim depreciation using this investment plus the amount of the mortgage as his basis.

If a federal tax lien asserted against the lessor in a lease financing or his successor could give the government a better right than the lender to the assigned rents, extensive safeguards against the creation of such a lien would be required. The lender would have to be as-

3. Recent amendments to the Internal Revenue Code have reduced the attractiveness of this arrangement to individuals in some situations by taxing a portion of the gain on the eventual sale of the property at ordinary income rates where part of the gain represents the recapture of depreciation deductions. As to real estate, see Int. Rev. Code of 1954 § 1250, added by the Revenue Act of 1964; as to personal property, see Int. Rev. Code § 1245, added by the Revenue Act of 1962.

sured that the lessor would not engage in any business that would produce a tax liability and might insist that the lessor not be permitted to transfer the leased property to a third person whose property might become subject to a tax lien. In addition, the arrangement to be made for the payment of the taxes becoming due from the lessor as the amount of its deductions declines would have to be either under the lender's control or backstopped by a lien-lifting or deficiency agreement of the lessee. Many lenders are currently not requiring safeguards of these various kinds.

The Statute and the Arguments

Section 6321 of the Internal Revenue Code of 1954 provides that the government shall have a lien for delinquent taxes on "all property or rights to property, whether real or personal, belonging to" the delinquent taxpayer. Under Section 6322, this lien attaches at the time of the assessment. However, as regards a "mortgagee, pledgee, purchaser, or judgment creditor," Section 6323(a) provides that the lien is not effective until notice of it is properly filed pursuant to state recording laws.

These statutory provisions and the case law applying them suggest two possible theories, both supported by respectable authority, on which an assignment of rents might be held to have priority over a subsequent tax lien. The first such theory involves the "threshold question"[4] of whether, by the assignment, the taxpayer has given up his property rights in the rents, thereby rendering them beyond the scope of the lien imposed by Section 6321. The second possible theory is predicated solely on priority in time, *i.e.*, the principle that "the first in time is the first in right." The Supreme Court has held that in order to achieve priority through antecedent creation the private lien must be "choate" and "perfected," but the case law as yet provides no wholly reliable guide to determining when this standard is met. The foregoing two theories are taken up separately below.

A third argument that might be relied upon is the argument that an assignee of rents by way of security is a "mortgagee," "pledgee," or "purchaser" of the rents within the meaning of Section 6323(a). This position seems less promising than the two theories mentioned above for two reasons. First, the private lien must meet the same standards of choateness and perfection that would give it priority if it were created before the tax assessment,[5] and, second, the courts

4. Aquilino v. United States, 363 U.S. 509, 512 (1960).

5. *E.g.*, Pioneer American Ins. Co. v. United States, 374 U.S. 84 (1963); R. F. Ball Constr. Co. v. United States, 355 U.S. 587 (1958); United States v. L. R. Foy Constr. Co., 300 F. 2d 207 (10th Cir. 1962); United States v. Chapman, 281 F. 2d 862 (10th Cir. 1960); Randall v. Colby, 190 F. Supp. 319 (N. D. Iowa 1961); First State Bank of Medford v. United States, 166 F. Supp. 204 (D. Minn. 1958).

have not been generally receptive to assignees' contentions that they fit into the stated categories.[6] However, in the case of lease financings in which the credit of the lessee is primarily relied upon for the repayment of the secured debt, a strong argument can be made that there is, in fact, a purchase by the assignee of the rents assigned. The form of the transaction, is, of course, opposed to this interpretation, but a court which was willing to concern itself with substance might justifiably adopt this position.

Absence of a "Right to Property"

An absolute assignment would, of course, leave the assignor with no residual interest to which a federal tax lien could attach. On the other hand, where the assignment, while perhaps absolute in form, is in fact made by way of security, the assignor's rights do not totally disappear and may be sufficient to serve as the nexus for a lien for federal taxes.

If an assignment for security purposes should be held to leave the taxpayer without a "right to property" within the meaning of Section 6321, the assignment would achieve paramountcy over the federal lien without necessarily being "choate" or "perfected" by federal standards. The benefits of avoiding the uncertainty of the "choateness" and "perfection" standards are such that it is worth considering the plausibility of an argument that an assignor of rents to secure a debt does not retain a property interest in the rents that is sufficient to support a lien for federal taxes.

Preliminary Considerations. Only an assignment under which the assignee possesses a present right to collect the amounts assigned would be likely to be regarded as divesting the assignor of his property right. An assignor may, if he wishes, specifically condition the assignee's rights on the non-performance of the secured obligation, in which case the assignee would be bound by such condition and would be treated as having no present right to receive payment of the assigned claim. Also, some assignments, while absolute on their face, are not intended to be immediately enforced by the assignee, who refrains from requiring the debtor to make payments to him until a default by the assignor occurs. Executory assignments of these types are not likely to be regarded as affecting the assignor's property right until such time as the assignment is enforced by the assignee upon the occurrence of a default in the performance of the secured obligation.

---

6. *E.g.*, R. F. Ball Constr. Co. v. United States, 355 U. S. 587 (1958); United States v. Chapman, 281 F. 2d 862 (10th Cir. 1960); Randall v. Colby, 190 F. Supp. 319 (N. D. Iowa 1961). *Contra*, United States v. L. R. Foy Constr. Co., 300 F. 2d 207 (10th Cir. 1962).

Where the proceeds collected by the assignee pursuant to a present assignment are to be applied to the reduction of the secured obligation, the assignment, while absolute in form, still creates only a security interest in the assigned claim. Such an assignment does not terminate the assignor's obligation to the assignee on the secured claim and is subject to termination in the event that the secured obligation is otherwise performed. Nevertheless, it creates more than a mere lien on the assigned claim, since, upon the giving of notice, the debtor on the claim (the lessee in a lease financing) becomes directly obligated to the assignee.[7] The assignment's status as merely a security assignment affects only the rights as between the assignor and assignee and does not disturb the primary right of the assignee against the debtor, at least until the secured obligation of the assignor is performed. Thus, the assignment is, in effect, a conditional conveyance to the assignee of the assigned claim and in this respect may be analogized to a mortgage. We have already noted, however, that the courts have generally refused to classify an assignee of contract rights as a "mortgagee" or "pledgee" under the tax lien statute.

The case law clearly establishes that whether the assignor retains a property right in the claim assigned that is sufficient to support a federal tax lien is a matter for determination under state law.[8] While most courts would recognize that a present security assignment is analogous to an ordinary mortgage insofar as the location of title is concerned, courts in states following the so-called "lien theory" of mortgages would be likely to hold that a present security assignment creates nothing more than a lien in favor of the assignee on a property right possessed by the assignor. A review of federal tax lien cases indicates that a number of courts have concluded from the fact that an assignment was given to secure a debt that nothing more than a lien was created, while other courts have determined that a present assignment, or an executory assignment which has become enforceable, has the effect of divesting the assignor's property interest in the assigned claim.

The Durham Lumber *case.* The search for a property right as a prerequisite to the existence of a tax lien achieved prominence as an analytical approach as a result of the Supreme Court's 1960 decisions in the companion cases of *Aquilino* v. *United States*[9] and *United States* v. *Durham Lumber Co.*[10] Both of these decisions were

---

7. *E.g.*, Unif. Comm. Code § 9-502(1). For treatment of the debtor's obligation to the assignee, see 3 *Williston on Contracts*, §§ 432-34 (3d ed. 1960); 4 *Corbin on Contracts*, §§ 881, 903 (1951, Supp. 1961).

8. The emergence of this principle was foreshadowed in United States v. Bess, 357 U.S. 51 (1958), and firmly established in Aquilino v. United States, 363 U.S. 509 (1960), and United States v. Durham Lumber Co., 363 U.S. 522 (1960).

9. 363 U.S. 509 (1960).

10. 363 U.S. 522 (1960).

concerned with whether a general contractor had a "right to property" in sums due him from the owner under a construction contract where subcontractors and materialmen had not been paid, and both resulted in judgments denying priority to the federal lien on the ground that the contractor had no such property right. Of the two cases, the *Durham Lumber* case is of particular interest on the question of the assignor's retained rights under an assignment of rents.

In *Durham Lumber,* the Supreme Court upheld a court of appeals determination[11] that North Carolina statutes, which obligated the owner to pay the claims of unpaid subcontractors out of any amounts withheld by him from the general contractor, prevented the general contractor from having a sufficient property right in the sums withheld to support a federal lien. Under the North Carolina statutes the legal relationships among the parties were similar to what they might have been in a state lacking a similar statutory framework if the general contractor had assigned his claim against the owner to the subcontractor as security for the amount owing on the subcontract. The subcontractor had a right of action against the owner for his unpaid bill, which the Supreme Court characterized as "direct" and "independent." To the extent that the owner had notice, he was obligated to satisfy subcontractors' claims and would remain so obligated even if he should make payment to the general contractor. Under the law of most states, an assignee by way of security would have had substantially identical rights against a debtor who had been given notice of the assignment and directed to make payments to the assignee.

The Supreme Court found a difference between the North Carolina subcontractors' rights and the rights of one holding a lien on the general contractor's claim and strongly indicated that this difference controlled the result:

> "It is said that we should regard the subcontractor's interest as equivalent to a lien on the general contractor's claim against the owner, over-looking the fact that the law of North Carolina, as interpreted by the Court of Appeals, indicates that there is no such claim."[12]

The court of appeals had determined that there was "no such claim" only in the sense that the subcontractor had a better claim to the fund in question:

> "The obligation of the owner to the subcontractor is, thus, primary; his obligation to the general contractor, secondary."[13]

A similar observation could be made about a debtor's relative obligations under a security assignment. The danger remains, however,

11. 257 F. 2d 570 (4th Cir. 1958).
12. 363 U.S. at 526, n. 4.
13. 257 F. 2d at 573.

that a court will characterize the security assignment as creating only a lien on the assignor's interest in the claim and will not recognize that the assignee has in fact the better claim against the debtor, which under the *Durham Lumber* analysis should be sufficient to subordinate a tax lien.

The Third Circuit's Halprin *Decision.* The strongest authority for applying the no-property principle to an assignment by way of security is *In re Halprin,*[14] a 1960 decision of the Court of Appeals for the Third Circuit. In that case, an assignment of amounts to become due under an executory contract was made to secure a current loan. The court held that when funds finally became due under the contract, the assignment, having divested the taxpayer's property right in the amounts payable, precluded the government. In discussing the relative rights of the parties, the court stated as follows:

> "Analytically, the three parties created a *new primary obligation* by substituting a new promise by Doniger to pay Commercial for Doniger's original promise to pay Halprin. . . . [A]fter Doniger agreed to make payment direct to Commercial, pursuant to Halprin's assignment, *Halprin ceased to be entitled even formally, much less beneficially, to receive Doniger's performance.*"[15]

Because the court clearly identified the three-party arrangement as one creating only a security interest in the assignee yet held this sufficient to divest the assignor's property right, the case is clear authority for applying the no-property principle to a security assignment.

The government has indicated that it would distinguish the *Halprin* case from another case involving an assignment of contract rights on the ground that the court in *Halprin* found a novation.[16] This analysis seems unwarranted, however, since Halprin, while not entitled to receive payment, was still obligated to perform the basic contract and to repay the loan secured by the assignment. In any event, the lessee's agreement in a typical lease financing to pay rents directly to the assignee would seem to make the case indistinguishable from the situation which the government characterizes as a novation.

Other authority to support the no-property analysis is sparse, although one 1961 decision of the New Hampshire Supreme Court[17] is as persuasive as the *Halprin* decision. The few other cases which might be cited[18] failed to give sufficient recognition to the security

14. 280 F. 2d 407 (3d Cir. 1960).
15. 280 F. 2d at 409. (Emphasis added.)
16. Memorandum for the United States, p. 9, n. 4, Crest Finance Co. v. United States, 368 U.S. 347 (1961).
17. Pitcher & Co. v. Ralph Nay Constr. Co., 103 N. H. 369, 172 A. 2d 360 (1961).
18. City of New York v. United States, 283 F. 2d 829 (2d Cir. 1960); In re City of New York, 5 N. Y. 2d 300, 184 N. Y. S. 2d 585 (1959),

nature of the assignments involved to constitute them reliable authority for adopting the no-property approach.

The Contrary Authority. Only one case has been found in which the no-property analysis was expressly held inapplicable where an assignment by way of security was concerned. And this case, *United States* v. *L. R. Foy Constr. Co.*,[19] decided in 1962 by the Court of Appeals for the Tenth Circuit, is not as clear a holding as it appears at first to be. In that case the court differentiated between an absolute assignment and a security assignment and held the no-property principle inapplicable because the assignment in question was of the latter variety. However, the assignee was apparently relying on the no-property analysis primarily to establish the superiority of liens securing advances made after the tax lien was filed. Obviously, the no-property argument has no application except to the extent that there is a debt giving the secured party a better claim than the assignor to the assigned sum. Because the result reached in the *Foy* case was exactly the same as that yielded by this understanding of the no-property analysis, the case should not be regarded as strong authority. Nevertheless, the court's statement that, in spite of the assignment, "the taxpayer had a property right which was subjected to a tax lien" may easily lead another court to read the *Foy* case as an outright rejection of the no-property principle.

The court in the *Foy* case seemingly failed to recognize that the assignor's property rights might have been *in part* divested by the assignment. In a large number of other cases, the question of whether the no-property principles applies to a security assignment has been wholly ignored and the issue of priority automatically reached and resolved either for or against the assignee.[20] Because the "threshold question" of whether a property right existed was skipped over in these cases, they may be considered either as tacit rejections of the no-property principle or merely as inconclusive on the issue. Most of these cases were decided prior to the Supreme Court's decisions in *Aquilino* and *Durham Lumber*. However, a few, like the *Foy* case, cited *Aquilino* or *Durham Lumber* and indicated an awareness of their general significance.

---

cert. denied, 363 U. S. 841 (1960); Davis v. J. W. Bateson Co., 2 A. F. T. R. 6138 (W. D. Ky. 1958); Duncan v. Criss Cross Publications, Inc., 59-1 U. S. T. C. ¶ 9149 (W. D. Okla. 1958).

19. 300 F. 2d 207 (10th Cir. 1962). In United States v. Damrow, 211 F. Supp. 615 (D. Wyo. 1962), the no-property principle was not applied because the court found the security assignment ineffective to give the assignee a direct right against the debtor on the assigned claim.

20. *E.g.*, United States v. Crest Finance Co., 291 F. 2d 1 (7th Cir.), *judgment vacated per curiam*, 368 U. S. 347 (1961); United States v. Chapman, 281 F. 2d 862 (10th Cir. 1960); Bankhead v. Maryland Cas. Co., 197 F. Supp. 879 (E. D. La. 1961); Arthur Co. v. Chicago Paints, Inc., 175 F. Supp. 50 (D. Minn. 1959); First State Bank of Medford v. United States, 166 F. Supp. 204 (D. Minn. 1958); Commercial Standard Ins. Co. v. United States, 146 F. Supp. 919 (N. D. Tex. 1956), *aff'd*, 254 F. 2d 432 (5th Cir. 1958).

Conclusions on the No-Property Argument. The Supreme Court has yet to apply the no-property analysis in a case involving a security assignment. Moreover, in one important case, the *Crest Finance* case discussed below, the Court has dealt *per curiam* with the choateness and perfection issue when the "threshold question" of whether a property right existed remained unanswered, suggesting that the applicability of the *Durham Lumber* analysis was not recognized. The government's memorandum to the Court in that case conceded that the assignee's lien was choate and perfected but argued that the no-property principle was in no way applicable. Under these circumstances, the future of the no-property principle may ultimately depend upon whether the courts apply the "choateness" and "perfection" requirements discussed below in such a way as to uphold assignments made for security purposes. If satisfactory results such as that in the *Crest Finance* case continue to be reached, the property rights approach is not likely to be used.

While it remains to be seen whether the apparently misleading language of the Tenth Circuit in the *Foy* case will outweigh the analysis in the *Halprin* case, the analysis in terms of property rights is more likely to prove useful in a state which follows the so-called title theory of mortgages than in states which regard mortgages merely as liens. A review of the decided cases indicates a correlation between the prevailing theory of mortgages and the responsiveness of courts to the no-property analysis in cases involving security assignments. The correlation is great enough to raise a question as to the potential usefulness of the no-property principle in a state where the courts are accustomed to regard all security interests as simple liens.

In states where the Uniform Commercial Code has been adopted, the chances for acceptance of the no-property analysis are much improved since the Code does away with a simple lien-theory or title-theory approach and gives superior rights of collection to an assignee. These rights seem sufficiently well established to satisfy the no-property test of the *Durham Lumber* case. Moreover, the *Halprin* case was decided under the Code and offers strong authority for a similar result in any Code state. The fact that the Code does not apply to an assignment of a real estate lease or of the rents thereunder[21] may in some cases leave the matter subject to previously prevailing doctrine and the attending uncertainty. It would be anomalous if, in a single state where the Code was in effect, a different rule should apply to an assignment of rents from real estate and an assignment of rents under a chattel lease.

21. Aquilino v. United States, 363 U. S. 509, 512 (1960).

PRIORITY IN TIME

Because the tax lien attaches only at the time of the assessment of the delinquent taxes, it is vulnerable to a simple argument based on priority in time if the assignment was previously executed. The Supreme Court has been receptive to the principle that "the first in time is the first in right," having first applied it to defeat in part a federal tax lien in *United States* v. *City of New Britain.*[22] In that case, which involved the relative priority of liens on the proceeds of a mortgage foreclosure sale, the city's statutory liens for unpaid taxes and water bills were held superior to the federal lien to the extent that they had become "choate" and "perfected" prior to the tax assessment. The *New Britain* case stands for the proposition that under certain conditions a pre-existing lien, while it may not constitute the lienor a "mortgagee, pledgee, purchaser, or judgment creditor" under Section 6323(a), may still attain priority over a tax lien by reason of antecedent creation.

The Choateness and Perfection Test Stated. The *New Britain* case provides a convenient starting point for pursuing the inquiry as to whether a lien is choate and perfected. In holding the city's lien for taxes and water rents sufficient to compete for priority with the federal lien, the Court said,

> "The lien 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."[23]

This language has been regularly cited as the clearest statement of the standard which the Court applies.[24] The Court has also made it clear that whether a lien is choate or perfected is a question of federal law and not simply a matter of whether the lien would be enforceable in a state court against an intervening lienor.[25]

The Ball *Case.* The first Supreme Court case involving the question of whether an assignment by way of security was choate and perfected was *R. F. Ball Constr. Co.* v. *United States.*[26] In that case, a subcontractor assigned its right to payments under the subcontract to its performance-bond surety as security for any obligation which might arise in favor of the surety, either by reason of the subcontractor's non-performance or otherwise. After the govern-

22. Unif. Comm. Code § 9-104(j).
23. 347 U. S. 81 at 84.
24. *E.g.,* Pioneer American Ins. Co. v. United States, 374 U. S. 84 (1963); Memorandum for the United States, Crest Finance Co. v. United States, 368 U. S. 347 (1961).
25. *E.g.,* Aquilino v. United States, 363 U. S. 509 (1960); United States v. Durham Lumber Co., 363 U. S. 522 (1960).
26. 355 U. S. 587 (1958), *reversing* 239 F. 2d 384 (5th Cir. 1958), *affirming* 140 F. Supp. 60 (W. D. Tex. 1956).

ment had filed its tax lien against the subcontractor, the subcontractor defaulted on another contract, the performance of which the surety had guaranteed under another bond. The district court's opinion indicates that the surety's claim under the assignment was based entirely on the obligation arising from this subsequent default.

The surety contended that its assignment constituted it a "mortgagee" under Section 6323(a). The Supreme Court reversed the decisions below and held *per curiam* for the government, stating without discussion that the surety's lien was inchoate and unperfected, and that therefore Section 6323(a) did not apply. The case seems to stand simply for the not unreasonable proposition that an assignment securing indebtedness of an uncertain amount to arise wholly in the future, if at all, is inadequate to subordinate a tax lien filed before the indebtedness arises. The case was also notable as being the first Supreme Court decision to impose the requirement of choateness and perfection on contractual liens. Before *Ball,* some commentators had suggested that the *New Britain* case was applicable only to statutory liens of the sort there involved.

Cases Relying on the Ball *Case.* The *Ball* case has been treated in numerous subsequent lower court decisions as having considerable significance.[27] In general, reliance on the *Ball* case has occurred in cases finding that an assignment made prior to the assessment of federal taxes was inchoate and unperfected by federal standards when asserted against a tax lien arising out of the assessment. In most of these cases, however, the indebtedness secured by the assignment arose prior to the tax assessment, making the applicability of the *Ball* case uncertain. Courts faced with this problem chose either to ignore this factual distinction or to discount its significance. The result was the subordination of security assignments to federal tax liens without a thorough analysis of the facts surrounding the assignment.

For the most part, the cases holding security assignments inchoate in the light of the *Ball* case do not clearly set forth facts from which it is possible to determine whether the assignments there in question were merely executory assignments not enforceable until a default on the secured obligation occurred or whether all of the steps neces-

27. United States v. Crest Finance Co., 291 F. 2d 1 (7th Cir.), *judgment vacated per curiam,* 368 U. S. 347 (1961); United States v. Chapman, 281 F. 2d 862 (10th Cir. 1960); Bankhead v. Maryland Cas. Co., 197 F. Supp. 879 (E. D. La. 1961); Arthur Co. v. Chicago Paints, Inc., 175 F. Supp. 50 (D. Minn. 1959); First State Bank of Medford v. United States, 166 F. Supp. 204 (D. Minn. 1958); Commercial Standard Ins. Co. v. United States, 146 F. Supp. 919 (N. D. Tex. 1956), *aff'd,* 254 F. 2d 432 (5th Cir. 1958). See also United States v American Employers Ins. Co., 192 F. Supp. 873 (D. N. Dak. 1961); United States v. Parks Constr. Co., 60-2 U. S. T. C. ¶ 9736 (N. D. Iowa 1960) (facts not clear as to whether assignment preceded tax assessment); Atlantic Ref. Co. v. Continental Cas. Co., 183 F. Supp. 478 (W D Pa. 1960) (assignment treated in dictum only); United States v. Pay-O-Matic, 162 F. Supp. 154 (S. D. N. Y.) *aff'd,* 256 F. 2d 581 (2d Cir. 1958).

sary to render the assignment enforceable against the debtor on the assigned claim had been taken. In most of these cases, however, the assignments in question appeared to be sufficiently executory to make the cases distinguishable from one involving a present assignment of rents to be immediately applied against the secured obligation. The usual situation was one in which the assignee had not given notice of the assignment to the debtor directing that payments be made directly to the assignee for application against the debt. In only one case did a court appear to reject the contention that an assignment of which the debtor had been clearly notified and which was by its terms presently enforceable constituted a choate and perfected security interest in the assigned claim. In that case, *Randall* v. *Colby*,[28] decided in 1961 in a district court in Iowa, the court found the assignee's lien inchoate apparently because it "had to do with moneys that would become due in the future under an executory contract." As noted below, this holding still poses a serious problem for assignees of rents in lease financings.

The Crest Finance *Case.* The *Ball* case was relied upon by the Seventh Circuit in its decision in *United States* v. *Crest Finance Co.*,[29] in which a federal tax lien was held superior to assignments of accounts receivable that had no visible defect on which a finding of inchoateness or imperfection might be based. The assignments were perfected under Illinois law,[30] the accounts subject to the assignments were identified (although documents evidencing the accounts were not transferred), and the amount of the lien was clear. Most significantly, the principal debtor was notified of the assignments and made payments directly to the assignee by checks payable to the assignor and assignee jointly. At the time the assignments were made, the assigned accounts represented amounts payable for work already performed under existing contracts for the hauling and compacting of excavated dirt. However, the amounts payable under the contracts were subject to revision upon a later determination by an engineer of the exact amount of dirt hauled. Without reference to the fact that the amounts owing were not finally determined, the court, stating its belief that the Supreme Court had established "a standard of choateness that few competing non-federal liens can achieve, short of judgment," held the assignments inchoate under the federal test.

The assignee petitioned the Supreme Court for a writ of certiorari. The Solicitor General filed a memorandum recommending to the

28. 190 F. Supp. 319 (N. D. Iowa 1961).

29. 291 F. 2d 1 (7th Cir.), *judgment vacated per curiam,* 368 U. S. 347 (1961).

30. This was determined finally on remand to the Court of Appeals after the Supreme Court vacated the earlier judgment. 302 F. 2d 568 (7th Cir. 1962). Subsequently, it was determined that the mechanic's liens of certain subcontractors were superior to the lien of the assignee of accounts receivable. 305 F. 2d 332 (7th Cir. 1962).

Court that the case be remanded for reconsideration in the light of the government's new conclusion that the *Ball* case, which it had relied on in the court of appeals, was not controlling. The government likewise conceded that, unless the assignments were required to be recorded under Illinois law, the lien of the assignment was choate and perfected under the *New Britain* principles. The government discussed at length the question whether the potential revision by the engineer of the amounts due on the assigned claims justified the decision of the court of appeals, concluding that this indefiniteness had no effect on the quality of the lien. In the light of these concessions by the government, the Supreme Court handed down a one-paragraph *per curiam* decision granting certiorari and vacating the judgment below. The Court stated that it agreed with the Solicitor General's view that the petitioner had a choate lien. This endorsement of the Solicitor General's position lends substantial authoritative significance to the memorandum filed by the government.

The Supreme Court's action in this case has opened the way for more thorough consideration of the facts of each case involving a security assignment. The acknowledgment by the government of the factual distinction between the assignment in the *Ball* case and an ordinary security assignment has gone far toward discrediting the series of decisions relying on *Ball*,[31] and the government's emphasis on the choateness and perfection tests of the *New Britain* case has helped to focus attention on those tests and to encourage careful application of them in the future. If security assignments are henceforth to be examined closely in the light of the *New Britain* tests and without the influence of the *Ball* case,[32] a present assignment of rents in a lease financing will have a better hope of competing successfully with a federal tax lien. One problem continues to exist, however.

The Unanswered Question. The Supreme Court's action in the *Crest Finance* case suggests that no requirement exists that the property subject to the assignee's lien be definite as to amount as long as it is specifically identified.[33] The degree of uncertainty as to the

31. On remand, the Court of Appeals clearly acknowledged that the Supreme Court's action was the result of a conclusion that the Ball case was not applicable on its facts. 302 F. 2d 568 (7th Cir. 1962). The Supreme Court expressly recognized the state of the facts in the Ball case in Pioneer American Ins. Co. v. United States, 374 U. S. 84 (1963).

32. The Supreme Court reiterated the New Britain tests and applied them to defeat a private lien in Pioneer American Ins. Co. v. United States, 374 U. S. 84 (1963). The Crest Finance case was followed in General Tel. Co. v. American Cas. Co., 226 F. Supp. 929 (S. D. Ill. 1964) (date of tax assessment not stated).

33. But see United States v. Pay-O-Matic, 162 F. Supp. 154 (S. D. N. Y.), *aff'd*, 256 F. 2d 581 (2d Cir. 1958), in which an attorney's lien obtained by an assignment of 25% of a condemnation award was held inchoate because "the amount of the lien was contingent on the outcome of a trial in the state condemnation court to fix the amount of the award." 162 F. Supp. at 156.

amounts owing under the assigned contracts (which were subject to revision by an engineer) did not induce the Supreme Court to find the assignment inchoate, and the Solicitor General in his memorandum to the Court stated as follows:

> The requirements 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.

This principle, which was apparently accepted by the Court, might also be applied to preclude a finding that an assignment of amounts to come due in the future under an executory contract is automatically inchoate. The government was careful in its memorandum to describe the assigned claims as "amounts due under the terms of a specific contract for work already performed" and to express no opinion on the question of the effect of an assignment of amounts to be earned in the future under an existing contract. Neither the Supreme Court nor any court of appeals has yet expressed an opinion on the choateness of a lien created by such an assignment. The only authority directly in point is *Randall* v. *Colby,* noted above, which held that a choate lien cannot exist on amounts yet to be earned.

In applying the requirement of the *New Britain* case that the property subject to the lien must be specifically identified, the government's memorandum in the *Crest Finance* case identified the property subject to the lien as the assigned accounts rather than the dollar amount owing on such accounts and thereby held that the requirement of specific identification had been met even though the amount owing was yet to be determined. Amounts to become due in the future under an executory contract are similarly identifiable prior to their being earned, and, hence, the identification of the contract (or lease) under which the assigned sums are to be earned would appear to be sufficient. Nevertheless, it is open to a court in the future to distinguish the *Crest Finance* case on the basis that in that case the work had already been performed. If a court were to make such a distinction, there would be no assurance that the present assignment of amounts to be earned in the future would be upheld. If the issue were deemed to be simply whether the property subject to the lien is adequately identified, the lien would probably stand up. If, on the other hand, the issue were framed more broadly, the absence of a specific enforceable right in being on the date of the tax assessment might result in a finding of inchoateness.

Where the assigned amounts are no longer subject to being earned by the assignor but have not yet become payable by the terms of the contract, a less difficult question is presented. In a recent deci-

sion,[34] the Court of Appeals for the Ninth Circuit held that a security assignment of installment payments under a contract of sale of real property was choate under the federal tests. The following statement by the court in that case points up the possible distinction to be drawn between the case of an assignment of amounts not yet earned and the case of an assignment of amounts not yet payable:

> 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.*[35]

In view of this holding and dictum, a case involving a net lease, such as is used in the typical lease financing, would permit a stronger argument for upholding the assignment than a case involving an assignment of ordinary rents under an ordinary real estate lease. In the case of the net lease, the obligation of the lessee is for all practical purposes absolute and unconditional because the lessor has no obligations to perform. Under such a lease, the rents may be said to have been earned when the lease is entered into although payment is deferred. On the other hand, a lease other than a net lease may be subject to infirmity in competition with a federal lien to the extent that the lessee's obligation to pay rent is regarded as conditioned on the lessor's performance of various covenants.

Whether a court would recognize the distinction between the two types of leases is, of course, problematical since there is a strong tendency to view the rents as being earned during the lessee's continued occupancy in either case. Careful drafting of the lease to eliminate all vestiges of the lessor's obligations is mandatory in a lease financing. However, it is possible that under state law the lessor's covenants of quiet enjoyment and other statutory obligations cannot be altogether eliminated, and, as a consequence, it might be difficult to establish that the lessee's obligation is entirely unconditional.

Conclusions on the Choateness Question. Since the *Crest Finance* case, the tests of choateness and perfection spelled out in the *New Britain* case are perhaps more than ever the best guide to determining the likelihood that a private lien will be upheld as against the government's lien for taxes. In applying the three requirements set forth in the *New Britain* case to assignments of rents in lease financings, no problem is encountered with respect to the identity of the assignee. The amount of the lien is likewise easily determined, being the entire unpaid principal amount of the lessor's notes. The ascertainment of the property subject to the lien of the assignment may prove more difficult, however, since the rents are amounts which

34. Hammes v. Tucson Newspapers, Inc., 324 F. 2d 101 (9th Cir. 1963).
35. 324 F. 2d at 103. (Emphasis added.)

are to come due in the future and are apt to be somewhat contingent in amount (if, for example, taxes or other expenses paid by the lessor or the assignee are to be reimbursed in the form of additional rent). Nevertheless, the assigned sums are clearly identifiable, being the total rents payable under a specific lease, and, at least as far as the basic rent is concerned, are generally fixed as to amount. The *Crest Finance* case makes it clear that the sums assigned may be variable in amount without affecting the choateness of the lien. And, while there has not yet appeared any basis for concluding that the issue is finally resolved, it seems likely that a private lien attaching to rents to fall due in the future will be upheld as choate and perfected.

Forecast and Conclusion

This article has reviewed two strong arguments that would be available to the assignee of rents in a typical lease financing if the federal government should assert a tax lien against the assigned rents. The recent re-assertion of the *New Britain* tests of choateness and perfection will probably result in emphasis on these tests to the exclusion of the analysis in terms of property rights. In view of the demise of the *Ball* case and other developments, it can now be concluded with some certainty that a present assignment of rents in a typical lease financing would be accorded priority over a federal tax lien to the extent of the indebtedness which the assignment secured on the date of the tax assessment giving rise to the federal lien.