

## 2018 GL1 - Lesson 5

### SUPERPRIORITIES, PURCHASE MONEY SECURITY INTERESTS, EQUITABLE SUBROGATION, AND THE MILLER ACT

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## I. INTRODUCTION AND OBJECTIVES

If any person liable to pay any tax neglects or refuses to pay after demand, the amount shall be a lien upon all property and rights to property, real or personal, belonging to such person. I.R.C. §

(Revised February 2018)

6321. Under section 6323(a), until notice is properly filed under section 6323(f), the federal tax lien (FTL) is not valid against a purchaser, security interest holder, mechanic's lienor, or judgment lien creditor.

For claimants listed in section 6323(a) priority is determined by statute. Section 6323, however, does not list all of the possible classes of creditors (e.g., state taxing authorities are not listed). For most other creditors, priority is determined under the judicial doctrine of choateness, where first in time is first in right. United States v. City of New Britain, 347 U.S. 81 (1954).

In addition to section 6323(a) and the general rule of “first in time, first in right,” there are additional provisions and rules regarding priority. This chapter will discuss the superpriorities arising under section 6323(b), as well as purchase money security interests (PMSIs), equitable subrogation, and the Miller Act.

At the end of this lesson, you will be able to:

- Identify the various superpriority interests provided by section 6323(b) and explain the consequences of superpriority status
- Identify PMSIs and determine their priority relative to the FTL
- Understand the application of equitable subrogation
- Understand the application of the Miller Act

## II. SUPERPRIORITIES

### ***A. In General***

Section 6323(b) provides a list of certain interests against which a FTL is not valid for priority purposes, even after a notice of federal tax lien (NFTL) has been filed. These are referred to as superpriorities. As discussed below, there are ten superpriorities listed in section 6323(b): (1) securities, (2) motor vehicles, (3) personal property purchased at retail, (4) personal property purchased in casual sale, (5) personal property subject to possessory lien, (6) real property tax and special assessment liens, (7) residential property subject to mechanic's lien for repairs and improvements, (8) attorneys' liens, (9) insurance contracts, and (10) deposit-secured business loans.

**Note:** Section 6324(c)(1) makes the section 6323(b) superpriorities applicable to estate and gift tax liens. See also I.R.C. §§ 6324A(d)(3)(A)(applicability of section 6323(b)(6)); 6324B(c)(applicability of rules in section 6323A(d)(3)).

There are two issues relevant to any superpriority determination: What property is covered or protected and who is the party protected. A third issue—whether the competing claimant has actual notice or knowledge of the FTL—is relevant to most, though not all, superpriority determinations.

**Note:** Actual notice or knowledge -- Section 6323(i) provides that for a particular transaction, an organization has actual notice or knowledge of any fact from the time the fact is brought to the attention of the individual conducting such transaction or from the time that the fact would have been brought to the individual's attention if the organization had exercised due diligence. The Service has the burden of proving actual notice or knowledge.

## ***B. I.R.C. § 6323(b)(1) through (10)***

### **1. Securities. I.R.C. § 6323(b)(1)**

#### **a) Property Covered**

(1) Purchaser of a security (I.R.C. § 6323(b)(1)(A)) - Section 6323(h)(4) defines security to include a variety of items. The definition includes many items generally recognized as securities (e.g., stocks, bonds, notes) as well as items not generally considered to be securities (e.g., money).

Occasionally, there is confusion regarding the definition of “money” in section 6323(h)(4). The Seventh Circuit in Christison v. United States, 960 F.2d 613, 615-616 (7th Cir. 1992) explained that the definition of money does not include accounts receivable or rights to receive money:

Interpreting the term “money” in Section 6323(h)(4) to include a generalized right to receive money would bring non-negotiable instruments as well as accounts receivable within the ambit of the definition. Congress would not have listed negotiable instruments specifically in the statute if it intended to include any right to receive money. The structure of Section 6323(h)(4) therefore strongly indicates a negotiable definition for the term ‘money.’

Accordingly, at least two circuits have specifically adopted a restrictive definition of money under this section. As Judge Chambers aptly explained in Worley v. United States, 340 F.2d 500, 502 (9th Cir. 1965), “money” under the definition of security in Section 6323(h)(4) does not include the right to receive money but is “the kind that one could bite, feel or pinch.” And as explained in United States v. First National Bank of Memphis, 458 F.2d 560, 563

(6th Cir. 1972), Congress carefully limited the definition of a security in Section 6323(h)(4) to negotiable instruments or money itself and did not intend to open the door to evidence of a right to receive money such as involved here. See also United States v. Bank of Celina, 721 F.2d 163, 169 (6th Cir. 1983). Other courts are in agreement. Rushmore State Bank v. Kurylas, 424 N.W.2d 649, 662-663 (S.D. 1988) (money in an escrow account not money under section 6323(h)(4)); In re Debmar Corp., 21 B.R. 858 (Bankr. S.D.Fla. 1982) (neither accounts receivable nor checking accounts are money under Section 6323(h)(4)).

(2) Holder of a security interest in a security (section 6323(b)(1)(B)) - Section 6323(h)(1) defines the term “security interest” as an interest in property acquired (with money or money’s worth) by contract for the purpose of securing payment or performance of an obligation or indemnifying against loss or liability.

## **b) Persons Protected -- IRC 6323(b)(1)(A) & (B), Purchaser of “security” and Holder of “Security Interest”**

(1) Purchaser without actual notice or knowledge.

i. Purchaser--defined, I.R.C. § 6323(h)(6). One who pays adequate and full consideration in money or money's worth for an interest in property (other than lien or security interest) that is valid under local law against subsequent purchasers without actual notice. For example, taxpayer buys a can of soup by giving cash to grocery clerk, who did not know that FTL encumbered the cash. The grocery clerk is a purchaser of a security because the definition of security includes money.

ii. Actual notice is not a factor if securities are bought and sold in the customary market (transaction between broker and buyer). Note: Protection may not extend to buyer with actual notice if broker sells securities from personal portfolio.

(2) Holder of security interest in a security without actual notice or knowledge.

- i. For example, pledgee of stocks or bonds.
- ii. Security interest--defined, I.R.C. § 6323(h)(1).

(3) A transferee of an interest is protected under section 6323(b)(1) to the same extent as the transferor. Treas. Reg. § 301.6323(b)-1(a)(1)(iii). Problem: "A" acquires a security interest in stock owned by "T," taxpayer, after NFTL has been filed, but without actual notice or knowledge of the lien. "A" has a superpriority. "A" thereafter transfers his security interest to "C," who has actual notice of the lien. "C" also has a superpriority because "C" succeeds to "A's" rights. If a tax lien is invalid against an initial holder of a security interest, it is also invalid against one who succeeds to the interest of the initial holder. See Treas. Reg. § 301.6323(b)-1(a)(2), Examples (1) and (2).

## **2. Motor Vehicles. I.R.C. § 6323(b)(2)**

### **a) Property Protected. I.R.C. § 6323(h)(3)**

Self-propelled vehicles registered for highway use under the laws of any state or foreign country.

**Note:** Service will not file a NFTA with any state department of motor vehicles.

### **b) Person Protected**

Purchaser without actual notice or knowledge at time of purchase and who acquires and retains possession before receiving actual notice or knowledge.

*Rationale:* Dealers taking in used cars and trucks cannot as a practical matter search county recording offices. The Service and consumers generally must rely on the certificate of title, on which other liens against the vehicle under state law normally appear.

**Note:** A lender on the security of a motor vehicle is not protected. Lender, regardless of state law requiring notation or memorialization of FTLs on the title certificates, should search for FTLs in the local office prescribed for filing such notices (on personal property) at the place of residence of the borrower. Accord I.R.C. §§ 6323(f)(1)(A)(ii) and 6323(f)(2)(B). The search for tax liens should include the previous owner.

### **3. Personal Property Purchased at Retail. I.R.C. § 6323(b)(3)**

#### **a) Property Protected: Tangible Personal Property (Treas. Reg. § 301.6323(b)-1(c)(1))**

(1) That was purchased at retail (not wholesale). Treas. Reg. § 301.6323(b)-1(c)(2); and

(2) That was sold in the ordinary course of the seller's trade or business. Treas. Reg. § 301.6323(b)-1(c)(2).

i. Sales on consignment do not qualify--actual owner of the goods is not in the business of selling them.

ii. Likewise, goods sold at auction do not qualify.

iii. Sales at a "going out of business" sale are protected if made in customary retail quantities. Bulk sales are excluded.

#### **b) Person Protected**

Purchaser (as defined in section 301.6323(h)-1(f)), unless purchaser knows the purchase will (or intends it to) hinder, evade, or defeat collection of tax.

### **4. Personal Property Purchased in Casual Sale. I.R.C. § 6323(b)(4)**

#### **a) Property Covered**

(1) Household goods, personal effects and other tangible personal property described in section 6334(a) (property exempt from levy).

(2) Purchased in a casual sale (not for resale). Treas. Reg. § 301.6323(b)-1(d)(1).

(3) Purchase price less than \$1,570 (for 2018). See Rev. Proc. 2017-58. As required by section 6323(i)(4) for liens filed after 1998, the amount is indexed annually for inflation.)

(4) Casual sale is a sale not in the ordinary course of the seller's trade or business. See Treas. Reg. § 301.6323(b)-1(d)(1).

### **b) Person Protected**

Purchaser without actual notice or knowledge of the existence of such lien, or that the sale is one of a series of sales. Treas. Reg. § 301.6323(b)-(1)(d)(2).

### **c) Rationale**

Purchaser of casual item of small value should not be required to check the county records, for example, when answering a classified advertisement for a used television. Series of sales may be an indication seller is having credit problems.

Example: Suppose a taxpayer advertises in a newspaper that he is selling his television, desk and refrigerator. A buyer sees the ad and as a result buys taxpayer's refrigerator for \$100. A Notice of Tax Lien was filed prior to the purchase. Buyer takes the refrigerator free of the FTL. See Treas. Reg. § 301.6323(b)-1(d)(3), Example (3).

## **5. Personal Property Subject to Possessory Lien. I.R.C. § 6323(b)(5)**

### **a) Property Covered**

(1) Tangible personal property.

(2) Subject to lien under local law securing reasonable price of repair or improvement.

### **b) Person Protected**

Holder of lien (for example, auto mechanic) if he or she is and has been continuously in possession from the time his or her lien arose. Actual notice or knowledge will not disqualify the interest. Treas. Reg. § 301.6323(b)-1(e).

### **c) Rationale**

Mechanic should not have to check county records before undertaking a repair job. Even if mechanic has actual knowledge of the tax lien, he or she is given priority because this work can be expected to enhance the value of the property.

## **6. Real Property Tax and Special Assessment Liens. I.R.C. § 6323(b)(6).**

### **a) Property Covered**

Applies only to real property.

### **b) Person Protected**

Taxing authority or someone taking the lien rights of the taxing authority, such as a purchaser at a tax sale, if such lien:

(1) Is entitled under local law to priority over security interest in such property that is prior in time; and

(2) Secures payment of:

- i. A tax of general application levied by any taxing authority based upon value of property (e.g., real estate tax).
- ii. A special assessment imposed directly on such property by any taxing authority for purpose of defraying the cost of any public improvement (e.g., for sewers, streets and sidewalks).
- iii. The charges for utilities or public services furnished to such property by a governmental entity (federal, state, or local).

If real estate taxes or special assessment liens, whenever they accrue, are ahead of mortgages under local law, they are also ahead of the FTL.

### **c) Rationale:**

This provision recognizes that any purchaser of real property at a federal tax sale would have to pay these local taxes to get clear title and thus would reduce his or her bid accordingly.

### **d) Actual Notice/Knowledge:**

Actual notice or knowledge of the FTL by the local taxing authority has no effect.

## **7. Mechanic's Lien on Residential Property. I.R.C. § 6323(b)(7)**

### **a) Property Protected:**

- (1) Real property subject to a lien for repair or improvement
- (2) that is an owner occupied personal residence

(3) and that does not contain more than four dwelling units. Treas. Reg. § 301.6323(b)-1(g).

**b) Person protected:**

Mechanic's lienor (defined in section 6323(h)(2) and section 301.6323(h)-1(b)) with or without actual notice if:

(1) Mechanic has a lien under local law for repair or improvement.

(2) The total contract price for labor and material is not more than \$7,840 (for 2018). See Rev. Proc. 2017-58. As required by section 6323(i)(4) for liens filed after 1998, the amount is indexed annually for inflation.)

i. Contract means the prime contract with the owner. If the prime contract exceeds \$7,840, then a subcontractor or supplier would not be protected even if the subcontract price was less than \$7,840.

**Note:** Before conceding priority, obtain a copy of the contract with the owner.

ii. Rationale: Unreasonable to expect workers on small jobs to search for NFTL. Actual notice does not invalidate the superpriority because the work adds to the value of the property and enhances the collection potential of the FTL.

iii. Many states include a "preferential lien" for wage claims that has priority over mechanic's liens. The wage claims may be accumulated and transformed into a collective labor claim that would not be a superpriority under section 6323. The resulting circular priorities may provide the Service with the leverage to share in a distribution of realty sale proceeds if the mechanics liens would normally consume all of the equity.

**8. Attorneys' Liens. I.R.C. § 6323(b)(8)**

**a) Property Protected**

Judgment or other amount in settlement of a claim or a cause of action, except such judgment or amount against the United States to the extent such judgment or amount is offset against any liability of the taxpayer to the United States. If the judgment does not offset the taxpayer's liability, section 6323(b)(8) does not apply. United States v. Tannenbaum, 2016

WL 4261755 (E.D.N.Y. 2016).

**b) Person Protected**

Attorney who has a lien under local law (essential element) or any enforceable contract right against such judgment or amount, to the extent of his or her reasonable compensation for obtaining judgment or procuring settlement, even if the attorney has actual knowledge of the FTL. Treas. Reg. § 301.6323(b)-1(h)(1). See Leathers v. Leathers, 856 F.3d 729 (10th Cir. 2017).

**c) Limits**

Applies to attorney services for litigation in court or an administrative tribunal, but limited to services in obtaining the judgment or settlement.

(1) Does not apply if the attorney renders services to collect or enforce a judgment. In re 18th Ave. Development Corp., 11 B.R. 61 (Bankr. S.D. Fla. 1981).

(2) Does not apply to a lien filed against the taxpayer for unpaid legal bills in previous litigation that didn't involve the property subject to the lien. See Morgan Stanley Smith Barney, LLC v. Frank Haron Weiner, PLC and Internal Revenue Service, 2015 WL 998437 (E.D. Mich. 2015).

**d) “Reasonable” Compensation**

Reasonable compensation is determined by the amount that customarily is allowed under local law for similar services, in light of the facts and circumstances of the particular case. North Carolina Joint Underwriting Assn. v. Long, 2008-1 U.S.T.C. ¶ 50,183 (E.D.N.C. 2008) (30% contingency fee arrangement not per se unreasonable compensation under state law).

**e) Rationale:**

In many states, an attorney has a first priority "charging" lien against any fund created by his or her efforts. Congress recognized this and also stated that the fee in such a case is similar in concept to a repair-person's lien; it enhances the value of the property.

**f) Note:**

In an interpleader action, if the government's lien attached before the filing of the interpleader action, the interpleading party's attorney's fees will not be allowed as a superpriority against the FTL. Campagna-Turano Bakery v. United States, 632 F.2d 39 (7th Cir. 1980).

## **9. Certain Insurance Contracts. I.R.C. § 6323(b)(9)**

### **a) Property Protected**

Life insurance, endowment, and annuity contracts.

### **b) Person Protected**

The insurance company under contract in the three following situations:

(1) If it makes a policy loan before it has actual notice or knowledge of the tax lien. Treas. Reg. § 301.6323(b)-1(i)(1)(i)

(2) After notice or knowledge, if it makes automatic premium loans (including interest), but only if the company was obligated by preexisting agreement to make them. Treas. Reg. § 301.6323(b)-1(i)(1)(ii)

(3) After the satisfaction of a levy pursuant to section 6332(b), unless and until the Service delivers to the insuring organization a notice (e.g., another levy notice, letter, etc.), executed after the date of such satisfaction, that the lien exists. Notification by the Service is satisfied by any means, including regular mail. (Notice does not have to be sent by certified or registered mail.) **Note:** Delivery is effective only from the time of actual receipt by the insurer. Treas. Reg. §301.6323(b)-1(i)(1)(iii)

### **c) Rationale:**

(1) Insurance company should not have to check filing records every time it makes a policy loan because it views such advance as a fulfillment of its contractual obligation under the terms of the policy. See United States v. Sullivan, 333 F.2d 100, 112-14 (3d Cir. 1964).

(2) Insurer is obligated by contract to make these loans.

(3) To avoid the necessity of insurer having to check whether all tax liabilities have been paid in each case in which previously there had been a levy on the policy.

### **d) Actual Knowledge**

Actual knowledge before the loan is made invalidates the superpriority, unless the loan is required by a preexisting agreement.

### **e) Example**

7/01/09            NFTL filed.

7/15/09 D taxpayer enters into a life insurance contract with Y. Contract provides if a premium is not paid, Y is to advance out of the cash loan value of policy an amount to maintain policy in force.

9/01/10 D fails to pay premium.

9/01/10 Y makes an automatic premium loan to keep the policy in force and knows of the tax lien at this time.

Question: Is the loan made by Y entitled to superpriority?

Answer: Yes, but only if Y did not have actual notice of the FTL when it entered into the contract.

## **10. Deposit-Secured Business Loans. I.R.C. § 6323(b)(10).**

### **a) Property Protected**

Section 6323(b)(10) provides a superpriority to a bank in connection with a deposit-secured loan to a depositor if:

(1) the bank did not have any actual notice or knowledge of the FTL and

(2) the loan was secured by “a savings deposit, share, or other account.”

Article 9 of the UCC allows a bank to obtain a security interest in a deposit account. Specifically, section 9-109 of Article 9 allows a security interest to be created in personal property. Section 9-109(d)(13), however, excludes consumer loans from the scope of Article 9, so a security interest may be created in only business loans. Section 9-314(a) provides that a security interest in a deposit account may be perfected by control. Under section 9-104(a)(1), a bank automatically has control when the bank maintains the deposit account. Section 9-104(b) provides that the bank still maintains control even if the depositor is allowed to withdraw funds from the account. There is no requirement that the bank file a UCC statement with the state. In effect, in most situations, the bank will automatically and secretly have perfected a security interest in the depositor's account. A bank's claim to a section 6323(b)(10) superpriority, however, is not a defense to a levy. Rev. Rul. 2006-42, 2006-2 C.B. 337.

### **b) Person Protected**

Bank or savings and loan association, as described in sections 581 or 591, to the extent of any loan made before actual notice or knowledge of the existence of the lien, if the loan is secured by such account. See section 6323(i) for special rules regarding organizational notice and knowledge.

### **c) Example:**

A savings and loan association publishes a monthly interdepartmental letter listing all depositors against whom a NFTL has been filed. If a loan officer neglects to consult the list before making a loan, the Service could charge the institution with actual notice.

## **III. PURCHASE MONEY SECURITY INTERESTS**

### ***A. In General***

A purchase money mortgage or security interest is defined under state law as a mortgage or security device taken to secure the performance of an obligation incurred in the purchase of real or personal property. For personal property, Article 9 of the UCC defines the creation and perfection of a security interest. State law must be checked in each case to determine whether a valid purchase money security interest exists and whether PMSIs are generally given elevated priority.

Section 6323(b) does not describe or refer to purchase money security interests. Nevertheless, Rev. Rul. 68-57, 1968-1 C.B. 553, relying on an explanation of the Federal Tax Lien Act of 1966 in the legislative history, treats a purchase money security interest as a superpriority. Rev. Rul. 68-57 provides as follows:

The Federal Tax Lien Act of 1966, P.L. 89-719, C.B. 1966-2, 623, does not refer to a purchase money security interest or mortgage. However, the General Explanation of the Act, as set forth in House of Representatives Report No. 1884, C.B. 1966-2, at page 817, states as follows:

Although so-called purchase money mortgages are not specifically referred to under present law, it has generally been held that these interests are protected whenever they arise. This is based upon the concept that the taxpayer has acquired property or a right to property only to the extent that the value of the whole property or right exceeds the amount of the purchase money mortgage. This concept is not affected by the bill.

In view of the legislative history of the Federal Tax Lien Act of 1966, the Internal Revenue Service will consider that a purchase money security interest or mortgage valid under local law is

protected even though it may arise after a NFTL has been filed.  
[Emphasis added.]

Commentators have criticized the phrase “valid under local law” in Rev. Rul. 68-57 as ambiguous. Zinnecker, When Worlds Collide: Resolving Priority Disputes Between the IRS and the Article Nine Secured Creditor, 63 Tenn. L. Rev. 585 (1996); Fetzer, The Purchase Money Security Interest and the Federal Tax Lien: A Proposal for Legislative Change, 36 Hastings L.J. 873 (1985). The Service’s position is that “valid under local law” means that the purchase money security interest (“PMSI”) must be perfected under local law. IRM 5.17.2.6.5.11(5). “It is difficult to imagine that Congress intended a non-perfected PMSI that is subordinate to other perfected Article 9 interests to enjoy priority over a federal tax lien.” 63 Tenn. L. Rev. at 667, n. 347. See also Slodov v. United States, 436 U.S. 238, 257 (1978) (in dicta, stating the IRC “and established decisional principles subordinate the tax lien ... to certain perfected security interests in ... collateral ... which is the subject of a purchase-money mortgage regardless of whether the agreement was entered into before or after the filing of the tax lien.” [emphasis added]).

## ***B. Creating the PMSI***

Pursuant to a security agreement under UCC section 9-103, a PMSI arises when a creditor advances money or credit to enable the debtor-taxpayer to purchase specific goods (new tangible personal property), and the money lent is used to acquire such goods. The newly purchased goods will serve as collateral for the loan. Generally, the PMSI arises in one of the following situations.

1. Seller advances credit—Buyer obtains possession of the goods, giving seller a security interest in the goods pursuant to a security agreement. Seller has not received full payment.
2. Bank/finance company advances money—Bank/finance company lends money to purchase goods after debtor-taxpayer signs security agreement. Seller is fully paid. See First Interstate Bank v. IRS, 930 F.2d 1521, 1526 (10th Cir. 1991). Typically, a bank/finance company establishes this by drafting a check payable to the seller of the goods. If the bank/finance company does not establish this, then it would have a regular security interest, not a PMSI. For example, Bank lent money to debtor-taxpayer to buy a tractor. Debtor-taxpayer misrepresented facts; debtor-taxpayer already owned tractor. Debtor-taxpayer used loan to vacation in Europe. Bank would not have a PMSI, and Rev. Rul. 68-57 would be inapplicable.

## ***C. Perfecting the PMSI***

To prime a NFTL, a creditor generally must perfect its PMSI. First National Bank v.

Coxson, 76-1 USTC 9450 (D.N.J. 1976). See United States v. Specialty Contracting and Supply, 140 B.R. 922 (Bankr. N.D. Ga. 1992) (the purchase money security interest primed the FTL because it was perfected). But see United States v. Heptner, 2016 WL 3344564 (M.D. Fla. 2016)(PMSI only has to be “valid,” not “perfected,” to prime federal tax lien under Rev. Rul. 68-57). This generally is not a burden for a PMSI in consumer goods, because there is no filing requirement. The PMSI automatically is perfected by the security agreement. However, there is a different rule for non-consumer goods. A PMSI in business goods (other than inventory or livestock), for example, must be perfected within a short period from the date that the debtor-taxpayer obtains the collateral, while a PMSI in inventory must be perfected before the debtor-taxpayer obtains the collateral. See UCC §§ 9-324(a) and (b).

### ***D. Losing a PMSI in Consumer Goods***

Some states have adopted a transformation rule for consumer goods, *i.e.*, a creditor might lose its PMSI in consumer goods if it allows the debtor-taxpayer to refinance or consolidate its debts. The reasoning behind the rule is that the debt restructuring transforms the “old” loan into a “new” loan with a security interest encumbering the debtor-taxpayer’s old assets. The debtor-taxpayer does not acquire any new goods with the new loan. Thus, the new loan would not create a PMSI, because, by definition, a PMSI exists only if the debtor-taxpayer acquires new goods. For an example of the transformation rule, assume NFTL filed on 1/2/09. A finance company lends debtor-taxpayer funds to purchase a television for personal use on 2/2/09 and pursuant to the security agreement, the finance company acquires a PMSI in the television. On 4/1/09, because of debtor-taxpayer’s financial problems, the finance company restructures the loan agreement, reducing monthly payments but extending the payment period. In some states, under the transformation rule, this would be a new loan agreement. The debtor-taxpayer did not use the new loan to acquire new consumer goods. Consequently, the creditor’s security interest under the new loan is only a regular security interest, not a PMSI. The PMSI from 2/2/09 was extinguished by the new agreement. Accordingly, in a lien priority dispute on 6/1/09, the NFTL primes the finance company’s regular security interest in the television.

The transformation rule does not apply to a PMSI in nonconsumer goods under UCC 9-103(f). Instead, the dual status rule may apply. The dual status rule preserves the original PMSI in a restructuring or refinancing for the original PMSI goods. After the restructuring or refinancing, the creditor has both a PMSI in the original goods and a regular security interest in other existing goods. For example, using the preceding example, assume that the debtor-taxpayer purchased the television to entertain customers at his restaurant. The television is not a consumer good; instead, it is business equipment. When the debtor-taxpayer restructures his loan agreement on 4/1/09, the new security agreement gives the creditor a security interest in the existing tables and chairs as well as the television. In a lien priority dispute on 6/1/09, under the dual status rule, the creditor has a PMSI in the television that primes the NFTL, but only a general security interest in the chairs and tables. The NFTL primes the general security interest

in the chairs and tables.

### ***E. Priority of PMSI Property:***

Even if a creditor establishes that a PMSI was created, in a lien priority fight the creditor must be able to identify the original property encumbered with the PMSI or property that was traceable to proceeds realized from the original property. E.g., Citizens Savings Bank v. Miller, 515 N.W.2d 7 (Iowa 1994).

There is a dearth of case law discussing the priority between a purchase money mortgage on real property and the FTL. The critical question is whether a purchase money mortgage is valid under local law. State law must be carefully examined to determine the definition of a purchase money mortgage.

Another question is whether the purchase money mortgage must be recorded. Generally, “[t]he priority of a purchase money mortgage is subject to being defeated by the operation of the recording acts. Under most recording acts a mortgage is protected against a prior unrecorded mortgage if he took his mortgage without knowledge and, in some states, if he recorded it first. If the subsequent mortgage so qualifies, the fact that the prior mortgage was for part of the purchase money is irrelevant.” Nelson & Whitman, Real Estate Finance Law 806 (3d ed. 1993). A similar result should be reached in a lien priority dispute between an unrecorded purchase money mortgage and a NFTL.

## **IV. EQUITABLE SUBROGATION**

### ***A. In General***

Section 6323(i)(2) provides that if local law allows a subsequent lien holder to be subrogated to the rights of a lien holder with priority over a FTL with respect to its newly created lien or interest, the subsequent lien holder shall be subrogated to such rights under federal law. Therefore, when a FTL is not valid with respect to a particular interest as against the holder of that interest, then the tax lien also is not valid with respect to that interest as against any person who, under local law, is a successor in interest to the holder of that interest. Treas. Reg. § 301.6323(i)-1(b). Under state law, equitable subrogation allows a junior creditor or claimant to step into the shoes of a senior creditor.

Equitable subrogation is defined under state law. Accordingly, there is also no single rule for determining equitable subrogation in all cases. As one example, under California law, courts (e.g., United States v. Han, 944 F.2d 526 (9th Cir. 1991)) apply a five-factor guideline for determining equitable subrogation: (1) payment was made by the subrogee to protect his own interest; (2) the subrogee had not acted as a volunteer; (3) the debt paid was one for which the subrogee was not primarily liable; (4) the entire debt has been paid; and (5) subrogation would not work any injustice to the rights of others.

Most equitable subrogation cases arise if a FTL has not been paid in situations involving the transfer of real property in nonjudicial foreclosures, voluntary sales, and refinancing. In a nonjudicial foreclosure under section 7425(b), if the Service is not provided notice, the purchaser takes real property encumbered with the FTL. In a voluntary sale, the Service files a NFTL; the taxpayer sells his real property; but due to some mishap, the FTL is not paid at closing. In refinancing, Bank 1 has the first lien, the NFTL is second, and Bank 2 satisfies the first lien on the property.

## ***B. Factors Considered by Courts***

The following factors guide courts in applying equitable subrogation, but these factors are not applied consistently.

### **1. Windfall to Service**

In California, if the Service enforces a FTL against a purchaser, the fact that the Service may recover more from the purchaser than it would have recovered from the taxpayer does not mean that the IRS would be unjustly enriched. United States v. Han, 944 F.2d 526 (9th Cir. 1991). “[N]o California court has said that equitable subrogation should apply solely because an existing lienholder is put in a better position.” Id. at 529. In contrast, in Dietrich Industries v. United States, 988 F.2d 568 (5th Cir. 1993), in interpreting Texas law, the court held that a factor weighing for equitable subrogation was that the Service would receive a windfall. “Denying subrogation in this case would give the government an unearned windfall in that it would elevate the government’s liens for no good reason.” Id. at 573.

### **2. Satisfying Entire Debt**

Under California law, equitable subrogation requires that the entire senior debt be paid. In contrast, in Dietrich Industries v. United States, 988 F.2d 568 (5th Cir. 1993), which interpreted Texas law, the court granted equitable subrogation even though the entire senior debt was not paid.

### **3. Real Party in Interest**

If a title insurance company fails to find a NFTL, the title insurance company may be sponsoring the litigation against the Service to reduce the title insurance company’s liability. In First Federal Savings Bank v. United States, 118 F.3d 532 (7th Cir. 1997), the court held that the bank that had refinanced the taxpayer’s real property was not equitably subrogated to the senior lien satisfied because the title insurance company was the real party in interest, not the bank.

### **4. Nonjudicial foreclosures**

In California, purchasers at forced sales might not qualify for equitable subrogation because the payments do not actually satisfy the debts. “What is important ... is that [the purchasers] knew that the forced sale of the property

would extinguish any liens regardless of how much they paid as a purchase price. Therefore, [the purchasers did not pay] money in order to satisfy the debt of another.” Fidelity Nat’l Title Insur. v. United States, 907 F.2d 868, 870 (9th Cir. 1990).

## **5. Volunteer**

While equitable subrogation is not provided to volunteers, the definition of a volunteer is not entirely clear. Interpreting California law, Fidelity Nat’l Title Insur., supra, denied equitable subrogation to a purchaser of property because he was a volunteer. Compare Han, supra (plaintiff was not a volunteer, even though he was a purchaser of property).

## **6. Actual and Constructive Knowledge**

Many states will not allow the equitable subrogation of a refinancing lender’s interest in property if the lender had actual knowledge of the intervening FTL. See, e.g., ContiMortgage v. United States, 109 F.Supp.2d 1038 (D. Minn. 2000). See also Dietrich, 988 F.2d at 572 (“In some jurisdictions constructive knowledge bars a subrogation claim [citation omitted], but, in Texas, a purchaser with constructive knowledge of the junior lien is not precluded from asserting equitable subrogation.”)

## **7. Assignment**

In those states in which equitable subrogation is not available or is difficult to achieve, the new lender may obtain an assignment of the prior mortgage to obtain priority over an existing FTL.

In addition, equitable subrogation may not apply if the bank seeking the benefit of equitable subrogation is the same bank that held the original obligation. Wells Fargo Bank v. Svenby, 2016 WL 4719883 (M.D. Ala. 2016).

# **V. THE MILLER ACT**

## ***A. In General***

If a subcontractor or supplier who provides labor or materials to a prime contractor is not paid for work done on behalf of the government, then sovereign immunity would leave them without the ability to recover directly against the government. To protect these subcontractors and suppliers, Congress enacted the Miller Act, currently codified at 40 U.S.C. §§ 3131 and 3132, in 1935. Department of the Army v. Blue Fox, Inc., 525 U.S. 255, 264 (1999). Specifically, the Miller Act requires that the prime contractor on certain federal construction projects furnish both a performance and a payment bond to the federal government “[b]efore any contract of more than \$100,000 is awarded for the

construction, alteration, or repair of any public building or public work of the Federal Government," thus allowing a subcontractor or supplier to sue on the surety bond. 40 U.S.C. § 3131(b).

### ***B. The Miller Act and Priority***

Although the Miller Act requires that prime contractors furnish payment and performance bonds on certain federal contracts and provides for the right to sue on the payment bond, it does not set forth the priorities as between any claim of the surety and any claim the government has for debts owed to it by the contractor.

However, the Supreme Court addressed this issue in United States v. Munsey Trust Co. of Washington, D.C., 332 U.S. 234 (1947). In Munsey Trust, the Court first held that the government, like any creditor, has the right to setoff amounts owed to a debtor against amounts the debtor owes to the government. 332 U.S. at 239. The Court rejected the surety's argument that it was entitled to the balance due because it was subrogated to the rights of the subcontractors, noting that subcontractors have no enforceable rights against the United States and that, in this case, the subcontractors had been paid.

The Court also considered the result if the contracts had not been completed. It noted that, if the government completed the job itself, the surety would be liable for any amount required to complete the job in excess of what the government would have paid the contractor. However, if the surety completed the job, the Court stated that the surety would be entitled to the retained moneys in addition to progress payments, as otherwise a surety would rarely agree to complete a job if it knew that, by doing so, it would lose more money than if it had allowed the government to proceed. Id. at 244.

Subsequently, lower courts have cited Munsey Trust to distinguish between those circumstances in which the surety makes payments pursuant to its payment bond and the government has the right to setoff, see Dependable Ins. v. United States, 846 F.2d 65, 67 (Fed. Cir. 1988); United States Fid. & Guar. v. United States, 475 F.2d 1377, 1383 (Ct. Cl. 1973); Barrett v. United States, 367 F.2d 834 (Ct. Cl. 1966), and those in which the surety satisfies its performance bond obligation and the government does not have the right to setoff. See Aetna Cas. & Surety v. United States, 845 F.2d 971, 976 (Fed. Cir. 1988); Aetna Cas. & Surety v. United States, 435 F.2d 1082 (5th Cir. 1970); Trinity Universal Ins. v. United States, 382 F.2d 317, 321 (5th Cir. 1967), cert. denied, 390 U.S. 906 (1968).

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