

COMPETING MECHANICS' AND FEDERAL TAX LIENS: CONFLICTS TRIGGERED BY A GENERAL CONTRACTOR'S DEFAULT*

THE inability of a general contractor to pay his debts often precipitates a conflict between subcontractors who seek to realize on mechanics' liens and the federal government as holder of a tax lien.¹ The subject matter of this conflict is a fund in the hands of the party who engaged the general contractor. Under the standard construction contract, this party (usually the owner of the premises),² while obligated to make periodic progress payments to the general contractor, retains a specified percentage of each payment until the contract is fully performed.³ Moreover, should the contractor default, the owner may withhold any sums which are due or unpaid the contractor.⁴ If the contractor defaults by failing to pay a subcontractor for goods or services, state law gives the subcontractor the right to place a mechanic's lien on the owner's premises⁵—a lien which the owner may attempt to discharge with

*United States v. Durham Lumber Co., 257 F.2d 570 (4th Cir. 1958), *cert. granted*, 79 Sup. Ct. 582 (1959).

1. For the hazards which frequently render contractors unable to pay their debts, see Comment, 68 YALE L.J. 138, 139-40 (1958). For the incidence of failure among construction firms see U.S. STATISTICAL ABSTRACT 498 (1957).

2. This party might also be an agent or lessee of the owner. See generally Comment, 68 YALE L.J. 138, 157-59 (1958).

3. PARKER & ADAMS, THE AIA STANDARD CONTRACT FORMS AND THE LAW 25 (1943). See also LLOYD, BUILDING AND BUILDINGS 18 (1888); CRESWELL, THE LAW RELATING TO BUILDING AND ENGINEERING CONTRACTS 181-82 (6th ed. 1957) (English treatise). In states with Pennsylvania-type mechanics' liens, see note 13 *infra*, a lump-sum contract is also used under which no part of the contract price may be paid to a contractor until performance is complete. Comment, 68 YALE L.J. 138, 145 (1958). The amount of money retained by the owner is therefore quite large, often large enough to satisfy the claims of both mechanics' lienors and the Government.

4. See PARKER & ADAMS, *op. cit. supra* note 3, at 40; Note, 66 YALE L.J. 797 (1957). See also Wolverine Ins. Co. v. Phillips, 165 F. Supp. 335, 342 (N.D. Iowa 1958); General Sur. & Ins. Corp. v. Martin Infante Co., 164 F. Supp. 923 (D.N.J. 1958); Closson v. Billman, 161 Ind. 610, 69 N.E. 449 (1904) (all discussing typical contract forms).

By overreporting the amount of work finished during the initial stages the contractor may severely limit the amount of money retained by the owner. See Comment, 68 YALE L.J. 138, 143-44 (1958). On the other hand, the retained fund must be augmented by the amount of any payments made in fraud of the mechanics' lienors. N.Y. LIEN LAW § 7; Maycumber v. Wolfe, 10 Misc. 2d 464, 171 N.Y.S.2d 44 (Sup. Ct. 1958); N.J. STAT. ANN. § 2A:44-85 (1952); Hasson v. Bruzel, 104 N.J. Eq. 95, 144 Atl. 319 (Ch. 1929); *cf.* J. D. Loizeaux Lumber Co. v. Steinberg, 102 N.J.L. 15, 131 Atl. 131 (Sup. Ct. 1925).

5. "A mechanic's lien is, essentially, the right of a builder to seek a judicial sale of the owner's property in order to satisfy unpaid claims." Comment, 68 YALE L.J. 138, 141 (1958). For further definition and explanation, see CREDIT MANUAL OF COMMERCIAL LAWS, 1959, at 376; ROCKEL, MECHANICS' LIENS § 2 (1909); Comment, 25 FORDHAM L. REV. 100, 101-02 (1956).

a fund retained by him under the contract.⁶ But when the contractor is delinquent in paying federal taxes,⁷ the owner-retained fund may be unavailable for this purpose, since it is subject to, and may be smaller than, the Government's tax claim against the contractor.

The federal tax claim against the fund derives from section 6321 of the Internal Revenue Code, which imposes a lien "upon all property and rights to property, whether real or personal, belonging to" a delinquent taxpayer⁸—here, the contractor. The subcontractor, on the other hand, usually pursues the fund not because he has a right to it but because it can be used to satisfy a claim which, by virtue of a mechanics' lien statute, he has against the owner's premises.⁹ Commonly, the mechanics' lien statute is of the New York or Pennsylvania type.¹⁰ The liability of the owner of premises is limited by New York-type statutes to the "amount due . . . under the [construction] contract" at the time a claimant files notice of his lien (plus any amount which becomes due thereafter).¹¹ Thus, since a retained fund represents the

6. See, *e.g.*, *United States v. Durham Lumber Co.*, 257 F.2d 570 (4th Cir. 1958), *cert. granted*, 79 Sup. Ct. 582 (1959); *United States v. Kings County Iron Works, Inc.*, 224 F.2d 232 (2d Cir. 1955); *Aquilino v. United States*, 3 N.Y.2d 511, 146 N.E. 2d 774, 169 N.Y.S.2d 9 (1957), *cert. granted*, 79 Sup. Ct. 577 (1959); *Robertson v. Huntley & Blazier Co.*, 351 Ill. App. 378, 115 N.E.2d 533 (1953); *Damato v. Leone Constr. Co.*, 41 N.J. Super. 366, 125 A.2d 302 (App. Div. 1956); *Cattani v. Korsan*, 32 N.J. Super. 210, 108 A.2d 110 (App. Div. 1954).

7. See Note, 66 YALE L.J. 797 n.2 (1957). The contractor is liable for amounts which were or should have been withheld from his employees' wages, see INT. REV. CODE OF 1954, § 3403, and for taxes assessed directly against his business, see *e.g.*, §§ 3111, 3301 (Federal Insurance Contributions Act taxes and employment taxes).

8. INT. REV. CODE OF 1954, § 6321 (formerly Int. Rev. Code of 1939, § 3670); see cases cited note 6 *supra*.

9. The statutes of only seven jurisdictions have been interpreted to give the subcontractor a direct interest in the retained fund. D.C. CODE ANN. §§ 38-105, -106 (1951), *Winter v. Hazen-Latimer Co.*, 42 App. D.C. 469 (D.C. Cir. 1914) (after notice, lienor has lien on amount due); ILL. REV. STAT. ch. 82, §§ 5, 21 (1957), *Hall v. Harris*, 242 Ill. App. 315 (1926); MISS. CODE ANN. § 372 (1957) (after notice, amount in owner's hands is bound), *Jake Strickland Lumber Co. v. Rheinart*, 115 Miss. 749, 76 So. 643 (1917) (lien upon amounts paid into court); N.J. STAT. ANN. § 2A:44-78 (1952), *Bankers Title & Abstract Co. v. Ferber Co.*, 15 N.J. 433, 105 A.2d 408 (1954); N.Y. LIEN LAW §§ 13(7), 36-a, *United States v. Kings County Iron Works, Inc.*, 224 F.2d 232 (2d Cir. 1955); N.C. GEN. STAT. ANN. §§ 44-6, -8 (1950), *United States v. Durham Lumber Co.*, 257 F.2d 570 (4th Cir. 1958), *cert. granted*, 79 Sup. Ct. 582 (1959); S.D. CODE § 39.0703 (1939), *Keeley Lumber & Coal Co. v. Dunker*, 77 N.W.2d 689 (S.D. 1956) (notice gives lienor a separate right from lien on property). The Ohio statute is virtually identical to that of North Carolina and therefore might be construed in the same manner. See OHIO REV. CODE ANN. § 1311.04 (Page 1953).

10. See 4 AMERICAN LAW OF PROPERTY §§ 16.106F (Casner ed. 1952); 2 GLENN, MORTGAGES § 351 (1943); Comment, 68 YALE L.J. 138, 142 (1958); Comment, 25 FORDHAM L. REV. 100, 101 (1956).

11. MASS. ANN. LAWS ch. 254, § 4 (1956). For similar acts, see ALA. CODE ANN. tit. 33, § 37 (1941); CONN. GEN. STAT. § 49-33 (1958); N.Y. LIEN LAW § 4. Statutes containing the "amount due" limitation are collected in Comment, 68 YALE L.J. 138, 142 n.22 (1958).

"amount due," and since paying the Government the "amount due" discharges an owner's contractual obligation, such payment generally terminates the owner's liability under a mechanic's lien.¹²

In contrast, most Pennsylvania-type statutes preserve the owner's liability and do not limit it to the "amount due."¹³ Nevertheless, paying the retained fund to the Government may substantially vitiate the subcontractor's statutory lien, for, once the average property owner pays the fund to the Government, he will not have other cash available with which to discharge the lien.¹⁴ The subcontractor must then forego his claim or foreclose on the premises, an expensive and time-consuming procedure.¹⁵

12. No case has specifically held that the owner's payment to the Government terminates his liability under a mechanic's lien. Nevertheless, since such payment eliminates the amount which measures the owner's liability, it may be assumed that that liability is thereby erased. Valid payment of other mechanics' lien claims does reduce the owner's liability. See *Herrmann & Grace v. Hillman*, 203 N.Y. 435, 96 N.E. 741 (1911); *Brainard v. County of Kings*, 155 N.Y. 538, 50 N.E. 263 (1898). *But see* *Richman v. City of New York*, 89 Misc. 213, 151 N.Y. Supp. 744 (Sup. Ct. 1915).

13. PA. STAT. ANN. tit. 49, § 21 (1930). These statutes follow one of two forms. Some impose unlimited liability on the owner. ALASKA COMP. LAWS ANN. § 26-1-9 (1948); ARK. STAT. ANN. § 51-601 (1948); COLO. REV. STAT. ANN. § 86-3-2 (1954); DEL. CODE ANN. tit. 25, § 2702 (1953); IDAHO CODE ANN. § 45-501 (Supp. 1957); IND. STAT. ANN. §§ 43-701, -709 (1952); IOWA CODE ANN. § 572.5 (1950); ME. REV. STAT. ANN. ch. 178, § 34 (1954); MD. ANN. CODE art. 63, § 1 (1957); MO. ANN. STAT. § 429.010 (1952); MONT. REV. CODES ANN. § 45-504 (1954); NEB. REV. STAT. ANN. § 52-102 (1952); N.M. STAT. ANN. § 61-2-2 (1954); ORE. REV. STAT. § 87.065 (1957); R.I. GEN. LAWS ANN. § 34-28-6 (1957); W. VA. CODE ANN. § 3723 (1955); WIS. STAT. § 289.02 (1953); WYO. COMP. STAT. ANN. § 55-201 (1946). Others limit the owner's lien liability to the contract price. GA. CODE ANN. § 67-2001(2) (1933); KAN. GEN. STAT. ANN. § 60-1403 (1950); KY. REV. STAT. ANN. § 376.010 (1955); MICH. STAT. ANN. § 26.281 (Supp. 1957); N.D. REV. CODE § 35-1207 (1943); OHIO REV. CODE ANN. § 1311.05 (Page 1953); OKLA. STAT. ANN. tit. 42, § 143 (1954); TENN. CODE ANN. § 64-1120 (1955).

Under all of the foregoing statutes payment in accordance with the contract will not reduce the owner's liability. See, e.g., *McClain v. Coleman*, 208 Ky. 163, 270 S.W. 736 (1925); *T. Dan Kolker, Inc. v. Shure*, 209 Md. 290, 121 A.2d 223 (1956); *Better Roofing Materials Co. v. Sztukowski*, 183 S.W.2d 400 (Mo. Ct. App. 1944); *Bryan v. Stempkowski*, 88 Pa. Super. 390 (1926). Under those limiting the owner's liability to the contract price, however, a payment discharging a lien will reduce the owner's remaining liability to lienors. E.g., *McClain v. Coleman*, *supra*; *Rieger v. Schulte*, 151 Ky. 129, 151 S.W. 395 (1912).

In some states with Pennsylvania-type statutes, the owner may limit his liability to the "amount due" by posting an appropriate bond prior to the commencement of work. E.g., CAL. CIV. PROC. CODE ANN. § 1185.1(6) (1955); COLO. REV. STAT. ANN. § 86-3-2 (1954); W. VA. CODE ANN. § 3743 (1955).

14. In cases involving a conflict between the Government and subcontractors, the aggregate of mechanics' liens is usually large. See, e.g., *In re Caswell Constr. Co.*, 13 F.2d 667 (N.D. N.Y. 1926) (subcontractor claims totalling \$24,000); *Robertson v. Huntley & Blazier Co.*, 351 Ill. App. 378, 115 N.E.2d 533 (1953) (\$3,400); *Cattani v. Korsan*, 32 N.J. Super. 210, 108 A.2d 110 (App. Div. 1954) (\$5,000); *United States v. Yates*, 204 S.W.2d 399 (Tex. Civ. App. 1947) (\$10,000).

15. Mortgage foreclosures ordinarily require at least a year and cost from \$250 to \$1,250. See *Harvey, Valuation of Mortgage Security*, 1957 U. ILL. L.F. 412, 450-51

Recognizing the subcontractor's practical interest in a retained fund, one Pennsylvania- and all New York-type statutes contain "stop notice" provisions.¹⁶ They stipulate that, after an owner receives notice of a subcontractor's claim, no payments may be made on the contract until the claim is satisfied. The owner is thus encouraged to utilize the fund to discharge mechanics' liens. Either because of a "stop notice" or because of the embarrassment which might ensue from using a retained fund to satisfy the inferior of two claims,¹⁷ an owner will often place the fund in the custody of a court, notify all claimants of his action, and permit the court to determine which claimant is entitled to the fund.¹⁸

Until 1958, the leading case on the proper disposition of retained funds as between competing mechanics' and federal tax liens was the Second Circuit decision in *United States v. Kings County Iron Works, Inc.*¹⁹ There, the

(table). Although exact figures are unavailable, lien foreclosure undoubtedly involves similar expense and time. See, e.g., N.Y. LIEN LAW § 43; ILL. REV. STAT. ch. 82, §§ 11-21 (1957) (same procedure used in mortgage and lien foreclosure cases).

16. For the New York-type acts, see, e.g., ALA. CODE ANN. tit. 33, § 46 (1941); FLA. STAT. ANN. §§ 84.04, .05 (1943); ILL. REV. STAT. ch. 82, § 27 (1957). A few New York-type jurisdictions do not explicitly prohibit payments after notice, but this prohibition is implicit in the "amount due" limitation. See CONN. GEN. STAT. § 49-33 (1958) (owner may credit only bona fide payments made prior to receipt of notice against amount due on lien claim); NEV. REV. STAT. § 108.150 (1957) (contractor may recover only unpaid contract price less amount of liens; owner may withhold amount of liens pending suit thereon); S.C. ANN. CODE § 45-254 (1952) (notice to owner required); UTAH CODE ANN. § 38-1-21, -22 (1953) (only payments to contractor before notice of lien will defeat lien).

The single Pennsylvania-type statute which compels an owner to withhold funds after a stop notice is filed is COLO. REV. STAT. ANN. § 86-3-2 (1954). Other Pennsylvania-type statutes allow the owner to withhold funds either after notice, ARIZ. CODE ANN. § 62-205 (1940); DEL. CODE ANN. tit. 25, § 2723 (1953); IND. STAT. ANN. § 43-709 (1952); MD. ANN. CODE art. 63, § 13 (1957); MICH. STAT. ANN. § 26.281 (Supp. 1957); MINN. STAT. ANN. § 514.07 (1947), or during the pendency of an action on a lien, ALASKA COMP. LAWS ANN. § 26-1-10 (1948); ARK. STAT. ANN. § 51-610 (1948); CAL. CIV. PROC. CODE ANN. § 1186.1 (1955); IDAHO CODE ANN. § 45-511 (1948); KAN. GEN. STAT. ANN. § 60-1406 (1950); MO. ANN. STAT. § 429.140 (1952); N.M. STAT. ANN. § 61-2-11 (1954); WYO. COMP. STAT. ANN. § 55-220 (1946).

17. An owner may place moneys in the custody of a court to avoid criminal liability for the misapplication of funds. See, e.g., FLA. STAT. ANN. § 84.07 (1943) (misapplication of funds constitutes embezzlement); N.Y. LIEN LAW § 36 (larceny). He may further wish to avoid the lien liability which can result from a failure to withhold. See, e.g., LA. CIV. CODE ANN. art. 2774 (1952); N.C. GEN. STAT. ANN. § 44-9 (1950). An owner may also place a fund in the hands of a court to avoid complex litigation. See *United States v. White Bear Brewing Co.*, 227 F.2d 359 (7th Cir. 1955), *rev'd per curiam*, 350 U.S. 1010 (1956); *Hulbert v. Hulbert*, 216 N.Y. 430, 111 N.E. 70 (1916).

18. See, e.g., *United States v. Durham Lumber Co.*, 257 F.2d 570 (4th Cir. 1958), *cert. granted*, 79 Sup. Ct. 582 (1959); *United States v. Kings County Iron Works, Inc.*, 224 F.2d 232 (2d Cir. 1955); *In re Caswell Constr. Co.*, 13 F.2d 667 (N.D.N.Y. 1926); *Bankers Title & Abstract Co. v. Ferber Co.*, 15 N.J. 433, 105 A.2d 408 (1954); *United States v. Yates*, 204 S.W.2d 399 (Tex. Civ. App. 1947).

19. 224 F.2d 232 (2d Cir. 1955).

Government claimed a retained fund in order to satisfy a general contractor's back taxes, and a subcontractor asserted both an ordinary mechanic's lien on the owner's property and a direct right to the fund itself. The latter right arose under the unusual New York statute providing that, upon the performance of services by a subcontractor, any funds retained by the owner but due the general contractor are to be held in trust for the subcontractor.²⁰ The Second Circuit determined the comparative rights of the subcontractor and the Government on the basis of the time-honored rule that the lien first in time is first in right.²¹ In accordance with an Internal Revenue Code provision, the court ruled that the time at which the tax assessment list was received in the revenue collector's office established the tax lien's relative priority.²² Then, following a series of Supreme Court decisions,²³ the court said that the relative priority of the mechanic's lien would depend on its time of perfection under federal law.²⁴ Because notice of the mechanic's lien had not

20. N.Y. LIEN LAW §§ 13(7), 36-a. Section 13(7) impresses a trust for the benefit of subcontractors on moneys received by a contractor under a contract and on moneys "due or to become due" the contractor. The same section allows the subcontractors to institute a civil action to enforce the trust and to pursue a right of action upon the obligation for the moneys due or to become due. The subcontractors therefore have a direct right of action against the owner. Although holding this right to be inchoate until reduced to judgment, both *Kings County* and *United States v. Aquilino*, 3 N.Y.2d 511, 146 N.E.2d 774, 169 N.Y.S.2d 9 (1957), cert. granted, 79 Sup. Ct. 577 (1959) (a case which relied upon *Kings County*), recognized its existence.

21. See 224 F.2d at 234. See also *Rankin v. Scott*, 25 U.S. (12 Wheat.) 175, 179 (1827) ("The principle is believed to be universal, that a prior lien gives a prior claim. . . ."), quoted in *United States v. City of New Britain*, 347 U.S. 81, 85 (1954). For other cases applying this doctrine to mechanics' liens, see, e.g., *In re Taylorcraft Aviation Corp.*, 168 F.2d 808 (6th Cir. 1948); *In re Caswell Constr. Co.*, 13 F.2d 667 (N.D. N.Y. 1926).

22. The provision was Int. Rev. Code of 1939, § 3671. A tax lien now arises at the time a tax assessment is made. INT. REV. CODE OF 1954, § 6322. The 1954 change is merely procedural, as assessments are no longer received from the Commissioner, but are now made in the District Director's office. Treas. Reg. § 301.6201-1 (1954). The change does not detract from any statements in the text of this Note based on the 1939 Code. See Plumb, *Federal Tax Collection and Lien Problems*, 13 TAX L. REV. 247, 248-49 nn.2, 13 (1958).

23. *United States v. Security Trust & Sav. Bank*, 340 U.S. 47 (1950) (attachment lien); *United States v. Gilbert Associates, Inc.*, 345 U.S. 361 (1953) (local tax lien); *United States v. Acri*, 348 U.S. 211 (1955) (attachment lien); *United States v. Liverpool & London & Globe Ins. Co.*, 348 U.S. 215 (1955) (garnishment lien); *United States v. Scovil*, 348 U.S. 218 (1955) (landlord's distress lien). Since *Kings County*, a series of Supreme Court decisions has treated mechanics' liens in the same manner as attachment and other liens were treated in the above cases. *United States v. Hulley*, 358 U.S. 66 (1958) (per curiam); *United States v. Vorreiter*, 355 U.S. 15 (1957) (same); *United States v. White Bear Brewing Co.*, 350 U.S. 1010 (1956) (same); *United States v. Colotta*, 350 U.S. 808 (1955) (same). For a discussion of the Supreme Court's summary treatment of these latter cases, see Brown, *Foreword, The Supreme Court, 1957 Term*, 72 HARV. L. REV. 77, 82 (1958).

24. 224 F.2d at 234. See also *United States v. Security Trust & Sav. Bank*, 340 U.S. 47, 49 (1950) ("The effect of a lien in relation to a provision of federal law for the

been filed as required by state statute until after the collector had received the tax list, the court held that the mechanic's lien could not have been federally perfected early enough to achieve priority over the tax lien.²⁵

Turning to the subcontractor's trust-fund right, the court found that it had arisen prior to delivery of the tax assessment list. But, the court continued, the right—analogue to that of an attachment lienor—was at all times inchoate. This conclusion was based on the same Supreme Court decisions used to determine the priority of the mechanic's lien. The Second Circuit found that, under the doctrine of these cases, the subcontractor's trust-fund right had never been perfected because it had never been reduced to judgment.²⁶

Generally applied, the *Kings County* rationale would always prevent a mechanic's lien, or any special right such as that in a New York trust fund, from being first in time. The Supreme Court cases which *Kings County* cited as determinative of when a subcontractor's lien rights perfect stand for the proposition that, as against federal tax liens, a state lien remains inchoate until the lienor and the property liened against are identified, and until the amount of the state lien is certain.²⁷ Literally interpreted, these criteria would ordinarily be met when a mechanic's lienor complied with state filing procedures.²⁸ But, in the context of a competing federal claim, the Supreme Court has defined perfection as synonymous with reduction to judgment.²⁹ Thus, the Court has held that the amount of a state lien remains uncertain until the underlying claim is reduced to judgment; prior to that event, the Court reasons, no certainty exists that the lien will continue to be asserted or that the amount stated in the lien notice is actually owing.³⁰ Similarly, the Court has ruled that property subject to a lien is not properly identified until that portion of the property needed to satisfy the lien is judicially ascertained.³¹ Hence, even if notice of a mechanic's lien were given at the earliest possible

collection of debts owing the United States is always a federal question."); HART & WECHSLER, *THE FEDERAL COURTS AND THE FEDERAL SYSTEM* 483-84 (1953).

25. 224 F.2d at 236.

26. *Ibid.* The Supreme Court cases are cited note 23 *supra*.

27. *United States v. City of New Britain*, 347 U.S. 81, 84 (1954); see cases cited note 23 *supra*. The Court's view of perfection was borrowed from decisions under REV. STAT. § 3466 (1875), 31 U.S.C. § 191 (1952). See Kennedy, *The Relative Priority of the Federal Government: The Pernicious Career of the Inchoate and General Lien*, 63 YALE L.J. 905 (1954); Plumb, *Federal Tax Collection and Lien Problems*, 13 TAX L. REV. 459, 469 (1958). For a discussion of the § 3466 standards, see 9 MERTENS, *FEDERAL INCOME TAXATION* § 54.12 (1958); Sarner, *Correlation of Priority and Lien Rights in the Collection of Federal Taxes*, 95 U. PA. L. REV. 739 (1947).

28. See, e.g., ALA. CODE ANN. tit. 33, § 41 (1941); CONN. GEN. STAT. § 49-34 (1958); N.Y. LIEN LAW § 9.

29. For discussion and criticism of this definition, see Anderson, *Federal Tax Liens—Their Nature and Priority*, 41 CALIF. L. REV. 241 (1953); Kennedy, *supra* note 27; Plumb, *supra* note 27.

30. See Plumb, *supra* note 27, at 470-71, nn.473 & 474 (collecting cases).

31. *Illinois ex rel. Gordon v. Campbell*, 329 U.S. 362 (1946); *United States v. Waddill, Holland & Flinn, Inc.*, 323 U.S. 353 (1945); Plumb, *supra* note 27, at 471-72.

moment, the lienor would probably be no more successful than was the *Kings County* subcontractor—whose trust right actually antedated delivery of the tax list.³² The lienor would still face the task, almost impossible in these days of congested courts, of reducing his lien to judgment before a tax lien arose.³³

Kings County is inconsistent with a few state cases in which mechanics' lienors received preference over the Government.³⁴ These cases reflect a general desire to circumvent the Supreme Court decisions cited in *Kings County* as controlling.³⁵ State dissatisfaction with the Supreme Court's view of perfection is not surprising, for the Court's definition operates without congressional support to weaken the force of local legislation intended to create lien rights.³⁶

32. "It is well settled that an unperfected mechanics' lien even though filed prior to a Government tax lien will be denied priority because it is not a perfected lien." *Wolverine Ins. Co. v. Phillips*, 165 F. Supp. 335, 346 (N.D. Iowa 1958).

33. On delay in state courts, see Harvey, *Valuation of Mortgage Security*, 1957 U. ILL. L.F. 413, 450-51 (table); INSTITUTE OF JUDICIAL ADMINISTRATION, CALENDAR STATUS STUDY (1956) (delay up to 40 months). See also ATTORNEY GENERAL'S CONFERENCE ON DELAY IN LITIGATION, PROCEEDINGS (1956).

34. The South Dakota, New Jersey, and Illinois courts have refused to apply the Supreme Court's perfection criteria in *Kings County* situations. See *Robertson v. Huntley & Blazier Co.*, 351 Ill. App. 378, 115 N.E.2d 533 (1953); *Bankers Title & Abstract Co. v. Ferber Co.*, 15 N.J. 433, 105 A.2d 408 (1954); *Scott v. Zion Evangelical Lutheran Church*, 75 S.D. 559, 70 N.W.2d 326 (1955). And the only state case decided after *Kings County* disagreed with the Second Circuit. *Damato v. Leone Constr. Co.*, 41 N.J. Super. 366, 125 A.2d 302 (App. Div. 1956). *United States v. Yates*, 204 S.W.2d 399 (Tex. Civ. App. 1947), reached a similar result, but it was decided before the Supreme Court's perfection doctrine was formulated in *United States v. Security Trust & Sav. Bank*, 340 U.S. 47 (1950).

35. See, e.g., *United States v. Hulley*, 102 So. 2d 599 (Fla.), *rev'd per curiam*, 358 U.S. 66 (1958); *United States v. Griffin-Moore Lumber Co.*, 60 So. 2d 589 (Fla. 1953); *United States v. Colotta*, 224 Miss. 33, 79 So. 2d 474, *rev'd per curiam*, 350 U.S. 808 (1955). Many courts have followed the Supreme Court's precedents with stated reluctance. See, e.g., *Kel Weatherstrip Co. v. Rankin*, 124 F. Supp. 555, 560 (D. Alaska 1954) ("Unquestionably there is much in [a contrary holding] . . . that appeals to reason and justice."); *Union Bldg. & Inv. Co. v. Forest Hill Apartments, Inc.*, 30 N.J. Super. 130, 135, 103 A.2d 648, 650 (L. 1954) ("While the equities are all in favor of [the mechanic's lienor] . . . I am reluctantly forced to the conclusion that [his] motion must be denied."). For a decision expressing disagreement in particularly strong terms, see *United States v. Vorreiter*, 134 Colo. 543, 307 P.2d 475, *rev'd per curiam*, 355 U.S. 15 (1957). See also authorities cited note 29 *supra*. *But see Fleming v. Brownfield*, 47 Wash. 2d 857, 290 P.2d 993 (1955).

36. "As an original matter it would seem questionable that Congress could be thought to have intended to upset or override prior commercial transactions giving rise to valid liens." Brown, *Foreword, The Supreme Court, 1957 Term*, 72 HARV. L. REV. 77, 84 (1958). In *United States v. Security Trust & Sav. Bank*, 340 U.S. 47 (1950), the majority decision which formulated the criteria for perfection gave no reasons for them other than that the same criteria were used under *Revised Statutes* § 3466, which applies to situations in which the party in debt to the Government has committed an act of bankruptcy. Justice Jackson concurred on the ground that the Internal Revenue Code of 1939 (like the 1954 Code) requires that notice of a tax lien be filed in a state-designated

Also inconsistent with *Kings County* is a 1958 Fourth Circuit case involving similar facts and law—*United States v. Durham Lumber Co.*³⁷ Like *Kings County*, *Durham Lumber* arose out of a contractor's inability to pay his debts, and settled the conflicting claims of a subcontractor and the federal government to an owner-retained fund. Here, too, the subcontractor alleged a direct right to the fund in addition to his New York-type mechanic's lien on the owner's premises.³⁸ Again, the direct right stemmed from atypical legislation: a North Carolina statute which, first, allows subcontractors to supply an owner with a list of amounts owed them by a general contractor, and, second, requires the owner who receives such a list to pay the subcontractors out of funds withheld from the general contractor for this purpose.³⁹ As a further parallel to *Kings County*, the Government's tax lien in *Durham Lumber* came into existence before the subcontractor had filed the notice establishing his lien.⁴⁰

The Fourth Circuit began its *Durham Lumber* decision by distinguishing the Supreme Court cases on which *Kings County* relied.⁴¹ In each of those cases, the delinquent taxpayer had an indisputable property interest in the property against which the Government asserted its tax lien; and the essential issue was whether the federal lien or a state lien had priority with re-

public office in order for the Government's claim to have priority over the rights of pledgees, mortgagees, purchasers, and judgment creditors. INT. REV. CODE OF 1954, § 6323. In giving such protection to a special class of creditors, Jackson reasoned, Congress indicated its intention that no other claimants should be protected from the Government lien. 340 U.S. at 53. Legislative history reveals no such intent. See Brown, *supra* at 84 nn.35 & 36. Nevertheless, recent decisions indicate that the Court has accepted Jackson's reasoning. *Id.* at 87. See also Kennedy, *supra* note 27, at 924 n.114; Plumb, *supra* note 27, at 468.

Four recent memorandum decisions indicate that the Court intends to adhere to its perfection criteria. *United States v. Hulley*, 358 U.S. 66 (1958); *United States v. Vorreiter*, 355 U.S. 15 (1957); *United States v. White Bear Brewing Co.*, 350 U.S. 1010 (1956); *United States v. Colotta*, 350 U.S. 808 (1955). In each case, the Court ignored *United States v. City of New Britain*, 347 U.S. 81 (1954) (city real estate tax liens held perfected) (a decision "hardly to be brushed aside summarily," Brown, *supra* at 86).

37. 257 F.2d 570 (4th Cir. 1958), *cert. granted*, 79 Sup. Ct. 582 (1959).

38. 257 F.2d at 573. For the North Carolina mechanics' lien statute, see N.C. GEN. STAT. ANN. § 44-6 (1950).

39. N.C. GEN. STAT. ANN. § 44-9 (1950). Section 44-8 requires the contractor to furnish an itemized statement showing amounts owed to subcontractors. Since in the instant case the contractor had not done so, the subcontractors filed a statement to protect their rights. 257 F.2d at 571.

40. Unlike that in *Kings County*, however, the tax lien in *Durham Lumber* also antedated the subcontractor's direct right to the fund. But this fact could not be used to distinguish *Kings County*, since *Kings County* had found for the Government.

41. 257 F.2d at 572. The Fourth Circuit distinguished by name only *United States v. White Bear Brewing Co.*, 350 U.S. 1010 (1956), a memorandum decision which came after *Kings County*. *White Bear*, in turn, cited no authority but followed the perfection doctrine as established in the cases relied upon by *Kings County*. See Plumb, *supra* note 27, at 471. For the cases relied upon by *Kings County*, see note 23 *supra*.

spect to the taxpayer's property interest.⁴² But, the Fourth Circuit said, the priority issue does not arise in *Durham Lumber* because the delinquent taxpayer at bar—the contractor—had no property interest in that portion of the owner-retained fund claimed by the subcontractor. The court then ruled that, inasmuch as section 6321 of the Internal Revenue Code establishes a lien only upon property “belonging to” a delinquent taxpayer, the Government may not impress a tax lien upon owner-retained moneys in which the contractor (that is, the delinquent taxpayer) has no property interest.⁴³

The Fourth Circuit considered state law as determinative of whether the contractor had a property interest in the owner-retained fund. In North Carolina, a contractor has no right to payment until he files notice that he has paid all the debts owed his subcontractors.⁴⁴ Since the *Durham Lumber* contractor had not paid his subcontractors and consequently had not filed the notice, the court ruled that the owner's obligation to his general contractor was subordinate to the subcontractors' interests.⁴⁵ For this reason, the court said that the Government, as claimant against the contractor, was entitled only to that portion of the fund remaining after the owner paid the subcontractors in full.⁴⁶

The court recognized, however, that its property-rights approach was radically different from the Second Circuit's *Kings County* doctrine of first in time, first in right. Accordingly, the Fourth Circuit attempted to distinguish *Kings County*. That case, the court said, involved a “very different situation” in which “the only question . . . was the one of relative priority of competing claims to the same fund.”⁴⁷ This reasoning overlooks the fact that, if the *Durham Lumber* rationale had been employed in *Kings County*, the latter would no more have presented “competing claims to the same fund” than did *Durham Lumber* itself. Like the North Carolina law govern-

42. The Supreme Court has applied its first-to-perfect doctrine in the cases cited note 23 *supra*. In each, the delinquent taxpayer was the undisputed owner of the property on which a tax lien had attached.

43. 257 F.2d at 574.

44. N.C. GEN. STAT. ANN. § 44-8 (1950). “The general contractor, before receiving any payment from the owner, is required to file with the owner a statement of all sums due subcontractors . . .” 257 F.2d at 572.

45. *Id.* at 575.

46. *Ibid.* See also *United States v. Winnett*, 165 F.2d 149 (9th Cir. 1947); *United States v. Graham*, 96 F. Supp. 318, 321 (S.D. Cal. 1951).

Arguably, the court might have decided for the Government on the basis of North Carolina's New York-type mechanics' lien statute, which limits the lien to the “amount due” the general contractor under the contract. N.C. GEN. STAT. ANN. § 44-6 (1950). The court could have reasoned that “due” means “owing to” and that, in order to sustain his claim, the mechanic's lienor must admit the contractor's right to the retained fund. This argument, however, distorts the purpose of the “amount due” limitation, which serves to protect the owner by limiting his liability, not to grant a property right to the general contractor. See, e.g., *Heckmann v. Pinkney*, 81 N.Y. 211 (1880); *Wright v. Roberts*, 43 Hun 413 (N.Y. 1887).

47. 257 F.2d at 574.

ing the rights of subcontractors, the New York trust-fund statute makes the full payment of all subcontractors a condition precedent to the general contractor's acquisition of any right in an owner-retained fund.⁴⁸ Thus, the relevant facts and local law in *Kings County* were the same as those which, in *Durham Lumber*, led to the holding that the Government's section 6321 tax lien attached only to that withheld amount remaining after the subcontractors had been paid. Moreover, this same section 6321 argument had been advanced and rejected in *Kings County*. And the Second Circuit, treating the federal claim as going to the entire withheld fund, had applied the test of first in time.⁴⁹

Apparently, the *Durham Lumber* court sought not only to distinguish but also, in the alternative, to impeach *Kings County*. In a later case—*Fidelity & Deposit Co. v. New York City Housing Authority*—the Second Circuit had looked to a delinquent taxpayer's construction contract and determined that, in effect, the provision for an owner-retained fund subordinated a section 6321 tax lien to a surety's interest in the fund.⁵⁰ Hence, the Fourth Circuit implied, the Second Circuit has itself overruled *Kings County* sub silentio.⁵¹ Actually, however, the ratio decidendi of *Fidelity & Deposit* was urged on the Second Circuit in *Kings County* in the form of a New York Court of Appeals decision which provided the basis of *Fidelity & Deposit*.⁵²

48. Although, in New York, owner-retained moneys may be paid the general contractor, he must hold them as a trustee for the benefit of subcontractors. The trust is created as they do their work and consequently arises before the contractor has any right to the trust fund himself. Thus, although the two statutes differ in form, both create the same condition precedent to the contractor's right to a retained fund. Compare N.Y. LIEN LAW §§ 13(7), 36-a with N.C. GEN. STAT. ANN. § 44-8 (1950).

49. 224 F.2d at 235.

50. 241 F.2d 142 (2d Cir. 1957), Note, 66 YALE L.J. 797.

51. 257 F.2d at 574. The Fourth Circuit, noting that a New York Court of Appeals decision, *Aquilino v. United States*, 3 N.Y.2d 511, 146 N.E.2d 774, 169 N.Y.S.2d 9 (1957), cert. granted, 79 Sup. Ct. 577 (1959), was at variance with *Durham Lumber*, stated that the New York court had wrongly relied on *Kings County* instead of relying on *Fidelity & Deposit*. The Fourth Circuit further observed that, if the New York court had relied on the latter case, *Aquilino* would not have been at variance with *Durham Lumber*. Since *Kings County* and *Aquilino* involved identical problems, the Fourth Circuit, by stating that the Second Circuit's decision in *Fidelity & Deposit* was contrary to *Aquilino*, implied that *Fidelity & Deposit* had overruled *Kings County*.

This indirect approach to an impeachment of *Kings County* is inconsistent with the court's treatment of *Fidelity & Deposit* elsewhere in *Durham Lumber*. For the Fourth Circuit also attempted to distinguish *Kings County* from both *Fidelity & Deposit* and *Durham Lumber* on the ground that *Kings County* was concerned with a situation different from that in either of the other cases. 257 F.2d at 574. Actually, however, *Fidelity & Deposit* is as indistinguishable from *Kings County* as is *Durham Lumber*—for the reasons set forth in the text accompanying notes 47-49 *supra*. Of course, *Fidelity & Deposit* can be distinguished as adjudging the claim of a surety rather than that of a subcontractor. See note 53 *infra* and accompanying text. But this fact is of no help in distinguishing *Durham Lumber* from *Kings County*, both of which passed on subcontractor claims.

52. 224 F.2d at 235. The New York decision was *United States Fid. & Guar. Co. v. Triborough Bridge Authority*, 297 N.Y. 31, 74 N.E.2d 226 (1947). In *Fidelity & Depos-*

The Second Circuit ruled that the New York decision established the rights of a surety rather than a subcontractor and therefore was not applicable in *Kings County*.⁵³ Moreover, the Second Circuit subsequently observed in *Fidelity & Deposit* that that case and the New York decision on which it relied were both consistent with *Kings County*.⁵⁴

In sum, *Durham Lumber* failed either to distinguish *Kings County* or to uncover precedent discrediting it. That the two decisions are in conflict is a fact apparently recognized by the Supreme Court, for it recently agreed to review both *Durham Lumber* and *Aquilino v. United States*, a New York Court of Appeals decision which followed the *Kings County* rule of first in time.⁵⁵

As between *Kings County* and *Durham Lumber*, the latter is more faithful to the terms of the Internal Revenue Code. Section 6321 specifically restricts a government lien to that portion of an owner-retained fund presently "belonging to" a contractor with a tax arrearage.⁵⁶ Before *Kings County*, all cases according priority to section 6321 liens involved delinquent taxpayers who had present rights in the property liened against.⁵⁷ When deciding this type of case, the Supreme Court was faced with conflicting interests of equal

it, the Second Circuit had said that it was bound by *Triborough Bridge*. 241 F.2d at 147. That decision favored a surety's claim over a federal tax lien on a retained fund. The New York court rested its decision on an interpretation of the construction contract between owner and general contractor. 297 N.Y. at 36, 74 N.E.2d at 228.

53. 224 F.2d at 235. The Second Circuit also ruled that the New York decision established that the rights of the surety to the fund were perfected so as to antedate the federal tax lien. *Ibid*. This ruling is inconsistent with the interpretation which, in *Fidelity & Deposit*, the Second Circuit subsequently gave the New York decision. The Second Circuit there ruled that the New York decision had established that the contractor had no property rights in an owner-retained fund. 241 F.2d at 144.

54. *Id.* at 145. The Second Circuit ruled that, whereas *Fidelity & Deposit* and the New York decision involved the property rights of the delinquent taxpayers, *Kings County* was concerned solely with the question of priority. The Second Circuit also noted that *Kings County* construed a statute similar to all lien statutes, the difference in vocabulary being ascribed to "peculiar local conditions." *Ibid*. Therefore, the court said, the delinquent taxpayer had an undivested property interest which he did not have in *Fidelity & Deposit*. *Ibid*. The Government, apparently, disagrees, and has suggested that a conflict exists between *Fidelity & Deposit* and *Kings County*. *Central Sur. & Ins. Corp. v. Martin Infante Co.*, 164 F. Supp. 923, 928 (D.N.J. 1958).

55. 79 Sup. Ct. 577 (1959). The New York Court of Appeals decision appears at 3 N.Y.2d 511, 146 N.E.2d 774, 169 N.Y.S.2d 9 (1957). The lower state court had followed the *Durham Lumber* rationale. 2 App. Div. 2d 747, 153 N.Y.S.2d 268 (1956).

56. INT. REV. CODE OF 1954, § 6321. "[T]he rights of the [tax] Collector do not extend beyond those of the taxpayer whose right to property is sought to be levied upon." *United States v. Graham*, 96 F. Supp. 318, 321 (S.D. Cal. 1951); see *United States v. Winnett*, 165 F.2d 149 (9th Cir. 1947); *Bankers Title & Abstract Co. v. Ferber Co.*, 15 N.J. 433, 105 A.2d 408 (1954).

57 See note 23 *supra*; *United States v. Scovil*, 348 U.S. 218 (1955); *United States v. Acri*, 348 U.S. 211 (1955). In *United States v. City of New Britain*, 347 U.S. 81 (1954), the only case in which Government lost, the delinquent taxpayer also owned the property before any liens arose.

substance and was, therefore, justified in preferring the first lienor to perfect.⁵⁸ In a *Durham Lumber* or *Kings County* situation, on the other hand, the delinquent taxpayer (the general contractor) has no present right to that portion of the fund in which subcontractors, by virtue of local law, have direct rights. And the general contractor would not obtain such a present right unless the subcontractors failed to assert their rights or, asserting them, were paid in full.⁵⁹ Absent a present right in the general contractor, a federal tax lien can attach to a withheld fund only if conditions precedent are ignored and the Government is granted a lien on property not "belonging to" the delinquent taxpayer.⁶⁰ So long, therefore, as subcontractors have direct rights in a retained fund, the first-to-perfect rule is inapposite in settling a section 6321 claim against the entire fund.

By disregarding the true nature of the Government's lien interest, the *Kings County* decision was able to employ a rule which implements a favored policy of tax administration—achieving uniformity of result in similar cases.⁶¹

58. Whether the Court properly found that the federal tax lien was the first perfected is another matter. See Anderson, *supra* note 29; Plumb, *supra* note 27, at 468; Wolfen & Cohan, *The United States as a Creditor for Taxes*, 35 TAXES 684 (1957).

59. See text accompanying note 45 *supra*.

60. In *Fidelity & Deposit*, the Second Circuit specifically noted that the construction contract made payment of subcontractors a condition precedent to the contractor's acquisition of rights in the fund. On that ground, the surety's claim was accorded superiority. 241 F.2d at 144. It might be argued that the contractor, having a right to the fund on satisfaction of the condition precedent, has a contingent right. In turn, the contingent right might be given superiority—the Supreme Court's perfection doctrine having classified the more substantial interest of the subcontractor as unperfected. Utilization of the perfection doctrine to, in effect, transform a contingency into a certainty would, however, constitute a startling innovation. In past cases, the Supreme Court has applied the doctrine solely to determine priority among liens representing equal substantive rights. See cases cited note 23 *supra*.

61. See, e.g., *United States v. Pelzer*, 312 U.S. 399 (1941); *Lyeth v. Hoey*, 305 U.S. 188 (1938); *Niagra Hudson Power Corp. v. Hoey*, 117 F.2d 414 (2d Cir. 1941); *Weil v. United States*, 115 F.2d 999 (2d Cir. 1940). For the suggestion that the uniformity doctrine should have been determinative in *Fidelity & Deposit*, see Note, 66 YALE L.J. 801 (1957). Compare text accompanying note 81 *infra*.

While the uniformity principle has been emphasized primarily in connection with the existence of tax liability, the Second Circuit apparently extended the principle's force into the area of collection. Compare cases cited above; *Commissioner v. Stern*, 357 U.S. 39 (1958). In *Stern*, a Kentucky statute was read to limit the federal tax liability of a beneficiary of a life insurance policy—sued for income tax deficiencies of an insured—to the amount of premiums paid in fraud of creditors. Considering the effect of that statute, Justice Black, dissenting, seemed to distinguish between uniform liability and uniform collection policy:

In my judgment it is a mistake to look to state law to decide . . . [the] liability [of a party for federal income taxes]. The laws of several States are bound to vary widely. . . . [L]iability for federal taxes should be determined by uniform principles of federal law

Of course, state law must be consulted to determine what property rights and interests a taxpayer actually has. But once these rights and interests are thus es-

The New York trust-fund provision, which requires that a retained fund be used to pay subcontractors ahead of a general contractor, is peculiar to that state.⁶² The Second Circuit seemed to fear that a precedent giving the subcontractor's trust-fund right proper recognition would cause the priority of federal tax liens to vary from state to state⁶³ in accordance with the various supplementary rights which the several states may grant.

In contrast, the *Durham Lumber* court evidently was not concerned with the problem of uniformity, for its opinion turned on a North Carolina law almost as rare as New York's trust-fund statute.⁶⁴ In the vast majority of states, a subcontractor's claim to withheld moneys is based on a mechanics' lien statute supplemented, possibly, by a stop-notice provision.⁶⁵ And satisfying a mechanic's lien would not be a condition precedent to a contractor's acquiring rights in an owner-retained fund, since a mechanic's lien attaches only to the owner's premises.⁶⁶ A stop notice, on the other hand, may or may not activate such a condition precedent. At present, the stop-notice provisions of but three jurisdictions have been construed to provide the subcontractor with a direct interest in a retained fund.⁶⁷ In the remaining stop-notice jurisdictions, a stop notice seems merely to divest a contractor of his already existing rights in a fund pending the discharge of mechanics' liens.⁶⁸ Conditions precedent and subsequent are susceptible of manipulation, however, and courts approving the result in *Durham Lumber* may interpret other stop-notice statutes as making the discharge of mechanics' liens a condition

established, their consequence for purposes of federal taxation is a matter of federal law.

Id. at 47-48.

62. N.Y. LIEN LAW §§ 7, 36-a. Only Wisconsin has a somewhat similar provision. WIS. STAT. § 289.02 (1953).

63. That this may have underlain the Second Circuit's decision is indicated by its reference to the uniformity principle, 224 F.2d at 235, and by its characterization of the New York trust-fund provision as a normal lien statute employing an unusual "vocabulary" for which "peculiar local conditions were responsible." 241 F.2d at 145.

64. N.C. GEN. STAT. ANN. §§ 44-8, -9 (1949). OHIO REV. CODE ANN. § 1311.04 (Page 1953) is virtually identical with the North Carolina statute. FLA. STAT. ANN. § 84.04 (1943) is somewhat similar in requiring a statement from the general contractor before the final payment can be made by the owner.

65. All states have mechanics' lien legislation. For those with stop-notice provisions, see note 16 *supra*.

66. Statutes granting the subcontractor only an ordinary mechanic's lien leave the general contractor's interest in the retained fund unaffected by the filing of liens. See, *e.g.*, UTAH CODE ANN. § 38-1-22 (1953); VT. STAT. § 2754(II) (1947); VA. CODE ANN. § 43-7 (1950).

67. See District of Columbia, Mississippi, and South Dakota statutes and cases cited note 9 *supra*. Four other states, however, provide the subcontractor with a direct interest in the owner-retained fund under provisions other than these providing a stop notice. See Illinois, New Jersey, New York, and North Carolina statutes cited note 9 *supra*.

68. See, *e.g.*, LA. CIV. CODE ANN. art. 2772 (1951); MASS. ANN. LAWS ch. 254, § 4 (1956); VA. CODE ANN. § 43-7 (1950).

precedent to the contractor's rights in a retained fund.⁶⁹ The *Durham Lumber* approach still would not achieve uniformity, however, since more than twenty states do not have stop-notice legislation.⁷⁰

In formulating a property-rights rule yielding nonuniform tax consequences, the Fourth Circuit cited the Supreme Court's post-*Kings County* decision of *United States v. Bess*.⁷¹ This case held that, under section 6321 of the Internal Revenue Code, property rights are defined by state law.⁷² *Bess* thus seems to invite disparate results and to sanction the rationale of *Durham Lumber*. But *Bess* did not resolve a conflict between state and federal liens, and the Supreme Court may not have intended it to govern such a conflict.⁷³ Nonetheless, the Fourth Circuit's use of that decision is not unjustifiable. Arguably, uniformity in tax collection is less important than finding an avenue whereby mechanics' lienors can escape the Supreme Court's singularly harsh view of what constitutes perfection in section 6321 cases.⁷⁴

If the *Durham Lumber* court sought to enunciate a property-rights doctrine confining, rather than a single decision avoiding, the Supreme Court's

69 The distinction between precedent and subsequent is based on differences in phraseology. Compare "no right until an accounting is rendered or subcontractors are paid," see, e.g., N.Y. LIEN LAW §§ 7, 36-a; N.C. GEN. STAT. ANN. § 44-8 (1950), with "a right until stop notice is filed," see statutes cited note 16 *supra*.

70. In some of these jurisdictions, the owner may withhold funds during the pendency of action on mechanics' liens. ALASKA COMP. LAWS ANN. § 26-1-10 (1948); ARK. STAT. ANN. § 51-610 (1948); CAL. CIV. PROC. CODE ANN. § 1186.1 (1955); IDAHO CODE ANN. § 45-511 (1948); KAN. GEN. STAT. ANN. § 60-1406 (1950); MO. ANN. STAT. § 429.140 (1952); N.M. STAT. ANN. § 61-2-11 (1954); WYO. COMP. STAT. ANN. § 55-220 (1946). Other states prohibit an action by the contractor for a specified period. IOWA CODE ANN. § 572.13, .14 (1950); NEB. REV. STAT. ANN § 52-101 (1952); OKLA. STAT. ANN. tit. 42, § 143 (1954). And Oregon allows the contractor to sue for only the amount due under the contract less the amount of lien claims. ORE. REV. STAT. § 87-070 (1957). Finally, some jurisdictions have no provision which would in any way protect the subcontractor's interest in the owner's use of retained funds. KY. REV. STAT. ANN. § 376.010 (1955); ME. REV. STAT. ANN. ch. 778, § 34 (1954); N.D. REV. CODE § 35-1201 (1943); R.I. GEN. LAWS ANN. § 34-28-1, -6 (1957).

71. 357 U.S. 51 (1958).

72. Section 6321 of the 1954 Code (§ 3670 of the 1939 Code) "creates no property rights but merely attaches consequences, federally defined, to rights created under state law . . ." 357 U.S. at 55. Three opinions were given in *Bess*. Four Justices accepted state law as determinative of the existence of property rights. Two Justices acknowledged the function of state law but partially dissented on other grounds. And three Justices concurred in the result but based their opinion on Justice Black's dissent in *Commissioner v. Stern*, 357 U.S. 39, 47 (1958), decided the same day as *Bess*. Black's dissent said that state law determines the existence of property rights. See note 61 *supra*. Thus, the entire Court agreed on the fact that, under § 6321, state law establishes whether property rights exist.

73. At issue in *Bess* were the property rights which a decedent's estate has in a life insurance policy on the decedent's life. 357 U.S. at 55.

74. For discussion and criticism of that view, see authorities cited notes 29, 36 *supra*.

first-to-perfect rule, it erred in gearing its opinion to the unusual North Carolina law on subcontractor rights. By looking instead to the building contract between owner and general contractor, as the Second Circuit did in *Fidelity & Deposit*,⁷⁵ the Fourth Circuit could have fashioned a rationale which would produce uniform results regardless of the peculiarities of state law. *Fidelity & Deposit* (later endorsed by the Supreme Court in the *Bess* case)⁷⁶ presented substantially the same problem as *Durham Lumber*: a contest between the Government and a surety who had paid off subcontractors. The Second Circuit's opinion was bottomed on the fact that the fund at issue had been retained under a standard building contract, which, according to the New York courts, made "proof that the contractor had paid" his subcontractors a "condition precedent" to payment of the general contractor.⁷⁷ Accordingly, the court felt constrained to follow a New York Court of Appeals ruling that "so long as [debts owed subcontractors] . . . were outstanding and unpaid and so long as [the owner] . . . had the right to withhold and apply, the contractor had no rights to the fund, and, consequently, no property interest therein upon which [the Government] . . . could place a lien."⁷⁸

Relying as it does on a standard contract between owner and contractor, rather than on a particular state statute, the *Fidelity & Deposit* rationale (albeit restricted by the Second Circuit to surety cases)⁷⁹ is more widely applicable than that of *Durham Lumber*. Indeed, the *Fidelity & Deposit* approach could be used in any situation requiring the determination of a contractor's property interest in an owner-retained fund. Most construction contracts are of standard form and contain the same provisions which *Fidelity & Deposit* found pertinent.⁸⁰ Furthermore, the language of those provisions is so clear that the "condition precedent" interpretation of the New York courts has been accepted by other states in surety cases.⁸¹ A different

75. 241 F.2d at 146; Note, 66 YALE L.J. 797, 800 (1957).

76. 357 U.S. at 55.

77. 241 F.2d at 144.

78. *Ibid.*, quoting from *United States Fid. & Guar. Co. v. Triborough Bridge Authority*, 297 N.Y. 31, 37, 74 N.E.2d 226, 228 (1947).

79. The Second Circuit refused to apply the *Fidelity & Deposit* rationale in *Kings County*. The court ruled that *United States Fid. & Guar. Co. v. Triborough Bridge Authority*, 297 N.Y. 31, 74 N.E.2d 226 (1947), a surety case, was not controlling in a *Kings County* fact situation. 224 F.2d at 235. On the other hand, *Triborough* was followed by the Second Circuit in *Fidelity & Deposit*, itself a surety case. See note 52 *supra*.

80. See PARKER & ADAMS, *THE AIA STANDARD CONTRACT FORMS AND THE LAW* 40 (1954). Under the standard construction contract a "failure by the contractor to pay for labor and material [is] just as much a failure to perform and carry out the terms of the contract as an abandonment of the work would have been." *Fidelity & Deposit Co. v. New York City Housing Authority*, 241 F.2d at 144, quoting from *United States Fid. & Guar. Co. v. Triborough Bridge Authority*, *supra* note 78, at 36, 74 N.E.2d at 228.

81. See, *e.g.*, *General Sur. & Ins. Corp. v. Martin Infante Co.*, 164 F. Supp. 923 (D.N.J. 1958); *United States Fid. & Guar. Co. v. Miller*, 143 F. Supp. 941 (W.D.N.C. 1956); *Great Am. Indem. Co. v. United States*, 120 F. Supp. 445 (W.D. La. 1954).

reading seems unlikely. Moreover, should there be no specific contractual provision making the payment of subcontractors a condition precedent to the general contractor's right to withheld moneys, the courts would undoubtedly infer such a condition precedent unless the contract specifically provided otherwise.⁸² Mechanics' lien policy in all states seemingly dictates that a general contractor's performance be considered incomplete so long as the owner remains liable,⁸³ and that, even when construction is complete, the general contractor receive only so much of an owner-retained fund as exceeds debts outstanding to subcontractors.⁸⁴ Thus, the Fourth Circuit's property-rights approach, if geared to the contractual rights of general contrac-

In these cases, the surety has prevailed on a "no debt" theory involving an examination of the standard construction contract. Prior to the emergence of this theory, the surety's claim was accorded superiority on any one of several grounds all of which became ineffective when faced with the Supreme Court's perfection doctrine. Thus, the surety was held to have been subrogated to the mechanics' lienors, *e.g.*, *United States Fid. & Guar. Co. v. Sweeney*, 80 F.2d 235 (8th Cir. 1935); *New York Cas. Co. v. Zwerner*, 58 F. Supp. 473 (N.D. Ill. 1944);—to have been the holder of an equitable lien, *e.g.*, *American Sur. Co. v. Louisville Municipal Housing Comm'n*, 63 F. Supp. 486 (W.D. Ky. 1945), *aff'd sub nom. Glenn v. American Sur. Co.*, 160 F.2d 977 (6th Cir. 1947); *In re Van Winkle*, 49 F. Supp. 711 (W.D. Ky. 1943);—and to have been the holder of a chattel mortgage, *R. F. Ball Constr. Co. Inc. v. Jacobs*, 140 F. Supp. 60 (W.D. Tex.), *aff'd per curiam*, 239 F.2d 384 (5th Cir. 1956), *rev'd per curiam*, 355 U.S. 587 (1958). He has also been held to be subrogated to the rights of the contractor. *E.g.*, *Hardaway v. National Sur. Co.*, 211 U.S. 552 (1909); *Henningsen v. United States Fid. & Guar. Co.*, 208 U.S. 404 (1908), but that rationale is clearly in conflict with the "no debt" approach. For a discussion of these various theories, see *Wolverine Ins. Co. v. Phillips*, 165 F. Supp. 335, 346 (N.D. Iowa 1958).

82. Suppose an owner contracts to pay a certain price and the contractor, under a contract making no mention of payment of subcontractors, hires laborers and orders material for the contracted job. Unless the contractor's payment of subcontractors is considered a condition precedent to his own payment, should the contractor not pay the subcontractors, the owner's liability under the contract will exceed the contract price (for the subcontractors will have mechanics' liens against the owner's premises). Such could not have been the intended result of a contract setting a single contract price. Therefore, payment of the subcontractors by the contractor should be deemed a condition precedent to the contractor's acquisition of any rights to an owner-retained fund. *Cf.* 3 CORBIN, CONTRACTS § 562 (1951).

83. State policy strongly favors subcontractors and has accordingly produced the mechanics' lien statutes. See *In re Taylorcraft Aviation Corp.*, 168 F.2d 808 (6th Cir. 1948); *United States v. Griffin-Moore Lumber Co.*, 62 So. 2d 589 (Fla. 1953); *City Lumber & Supply Co. v. Fisher*, 256 Wis. 402, 41 N.W.2d 285 (1950). Thus, these statutes are liberally construed. See, *e.g.*, *T. Dan Kolker, Inc. v. Shure*, 209 Md. 290, 121 A.2d 223 (1956). In order to effectuate the policy behind these statutes, absent a contractual provision for the payment of subcontractors, their interest would doubtless be protected by making their payment a condition precedent to the general contractor's acquisition of any right in the fund. *Cf.* *Robertson v. Huntley & Blazier Co.*, 351 Ill. App. 378, 115 N.E.2d 533 (1953); 3 CORBIN, CONTRACTS § 701 (1950).

84. Substantial performance under the contract would entitle the contractor to only that portion of the contract price remaining unpaid less an amount necessary to compensate the owner for any damage to him caused by defects in the general contractor's

tors, would enable mechanics' lienors to prevail over the Government in all situations similar to that in *Durham Lumber*.⁸⁵

This modification of *Durham Lumber* would, however, raise certain problems. The subcontractor who contested the Government's lien in that case had a personal, statutory right to the retained fund. Absent such a right or broadly construed stop-notice legislation, a subcontractor's rights consist solely of his mechanic's lien against the owner's premises.⁸⁶ Hence, while payment of the subcontractor would be a condition precedent to the general contractor's acquiring a right in the retained fund, the owner will have exclusive rights therein pending the occurrence of the condition precedent. Only a claimant, such as a surety, who is subrogated to the owner's rights succeeds to the owner's defense that the contractor has no rights in the fund.⁸⁷ A subcontractor, however, must rely on a contract to which he was not a party in order to defeat a federal tax lien purportedly attaching to a general contractor's interest in the fund. And, ordinarily, one may not assert the title of a non-litigant—here, the owner—in order to defeat an opposing party's claim.⁸⁸

Nonetheless, section 6321 of the Internal Revenue Code would seem to dictate an exception to the rule forbidding inquiry into the title of nonlitigants. By imposing a tax lien only on property "belonging to" a delinquent taxpayer (the general contractor), that section requires a determination of the contractor's rights to an owner-retained fund irrespective of the opposing claim-

performance. See *Damato v. Leone Constr. Co.*, 41 N.J. Super. 366, 125 A.2d 302 (App. Div. 1956); 3 CORBIN, CONTRACTS § 701 (1950). Mechanics' lien liability could be deemed to flow from such a defect.

85. The Government has urged, however, that private contractual provisions cannot diminish the Government's rights under the tax statutes. See *United States v. Kings County Iron Works*, 224 F.2d 232 (2d Cir. 1955); *United States v. Manufacturers Trust Co.*, 198 F.2d 366 (2d Cir. 1952). "It has therefore been urged that the contractor's interest in any funds which have been earned is a right to property subject to the tax lien, notwithstanding contractual provisions limiting the contractor's right to payment." Note, 66 YALE L.J. 797, 800 n.17 (1957). Although this argument was accepted in *Kings County*, the Second Circuit later rejected it in *Fidelity & Deposit Co. v. New York City Housing Authority*, 241 F.2d 142, 144 (2d Cir. 1957). Other federal courts have taken the *Fidelity & Deposit* approach in surety cases. See note 81 *supra*. If successful, this argument might give the Government funds which the contractor never actually earned, for he may have overreported the amount of work done before his default. Owner-retained percentages would then exceed the proper measure of the contractor's performance. 66 YALE L.J. at 800 n.17.

86. See text accompanying note 69 *supra*.

87. "Under the usual rule of subrogation a surety who satisfies the claims of his principal's creditors acquires the rights of those creditors and any security held by them." Note, 66 YALE L.J. 797 (1957); see, *e.g.*, *Lacy v. Maryland Cas. Co.*, 32 F.2d 48 (4th Cir. 1932); *Alabama-Tennessee Natural Gas Co. v. Lehman-Hoge Scott*, 122 F. Supp. 314 (N.D. Ala. 1954). *But cf.* *United States v. Munsey Trust Co.*, 332 U.S. 234 (1947).

88. The general rule is that a defendant may not set up a defense in favor of a third party. See, *e.g.*, *Los Angeles First Nat'l Bank v. Northrup*, 120 Cal. App. 677, 8 P.2d 528 (1932); *Ducros v. Gottschalk*, 25 La. Ann. 233 (1873).

ant's identity.⁸⁹ A court could readily make this determination by examining the construction contract. Thus, a contract-oriented *Durham Lumber* approach would present difficulties, but far from insurmountable ones.⁹⁰ More positively, this approach, while circumventing the Supreme Court's much-maligned first-to-perfect cases, would achieve uniform results and thereby implement the tax policy favored in *Kings County*.

89. See INT. REV. CODE OF 1954, § 6321; authority cited note 72 *supra*.

90. If the subcontractor could be considered a third-party creditor beneficiary of the construction contract, these difficulties would disappear. The subcontractor could then be subrogated to the owner's rights in the retained fund—the right to receive the fund on default by the general contractor. See 2 WILLISTON, CONTRACTS § 364 (rev. ed. 1936). The subcontractor would not be a third-party beneficiary, however, unless the contractor's promise to pay his subcontractors was made to the owner "primarily" for the benefit of the subcontractors. See 4 CORBIN, CONTRACTS § 776 (1951). And such a promise would ordinarily be elicited by the owner for his own benefit (to avoid mechanics' lien liability) rather than for the benefit of the subcontractor. See 2 WILLISTON, *op. cit. supra* § 372.