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Liens: Priority of Mechanic's Lien over Small Business Administration Mortgage (Hammer v. Chapin, D. Mont. 1966)

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RECENT DECISIONS

LIENS: PRIORITY OF MECHANIC'S LIEN OVER SMALL BUSINESS ADMINISTRATION MORTGAGE.—The plaintiff's predecessor performed work and supplied materials for a building on defendant's land, and filed a notice of lien within the statutory time.¹ In an action to foreclose the lien, the defendant Small Business Administration² sought to establish the priority of its mortgage over the lien, although it had been made after notice of the lien had been filed. *Held*, the mechanic's lien has priority over the mortgage.³ *Hammer v. Chapin*, 256 F. Supp. 818 (D. Mont., 1966).

The exact problem presented by this case was covered neither by statute nor by case law.⁴ The applicable federal statute does not give priority to SBA liens, although it does subordinate them to certain tax liens.⁵ Therefore, priority had to be sought elsewhere. When the debtor is insolvent, express priority is given to debts owing the United States, whether secured by liens or otherwise.⁶ A number of cases involving the insolvency statute were called to the attention of the court, but were rejected because the debtor was solvent. Other cases involving the tax lien statutes were likewise summarily rejected, since no tax lien was involved.⁷

In the absence of legislation to the contrary, the common law rule of "first in time is first in right" has generally been adopted in determining lien priorities.⁸ It is widely accepted and applied where the priority of the United States is not made paramount by statute,⁹ and it has been applied to federal mortgage liens.¹⁰

¹REVISED CODES OF MONTANA, 1947, § 45-502. (Hereinafter, REVISED CODES OF MONTANA will be cited R.C.M..)

²The United States of America is the defendant named in the caption of the report. (Hereinafter, Small Business Administration will be cited SBA.)

³R.C.M. 1947, §§ 45-501 to 45-512, particularly § 45-506, which provides that ". . . liens attach . . . in preference to any prior lien, encumbrance, or mortgage upon the land . . ." and § 45-504, providing that such liens ". . . shall be prior to and have precedence over any mortgage, encumbrance, or other lien made subsequent to the commencement of work on any contract for the erection of such building, structure, or other improvement."

⁴Instant case at 820.

⁵15 U.S.C. § 646 (1958).

⁶31 U.S.C. § 191 (1958).

⁷26 U.S.C. § 6321 (1954).

⁸*Rankin v. Scott*, 25 U.S. 177, 179 (1827); *United States v. New Britain*, 347 U.S. 81, 85 (1954); *In re Lehigh Valley Mills, Inc.*, 341 F.2d 398 (3d Cir. 1965); *United States v. Christensen*, 218 F. Supp. 718, 729 (D. Mont. 1963).

⁹*Meyer v. United States*, 375 U.S. 233, 236 (1963); *United States v. New Britain*, *supra* note 8, at 85; *United States v. City of Greenville*, 118 F.2d 963, 966 (4th Cir. 1941). See also *United States v. Gilbert*, 345 U.S. 361, 365 (1952).

¹⁰*United States v. County of Iowa*, 295 F.2d 963, 966 (4th Cir. 1961) citing *City of New Brunswick v. United States*, 276 U.S. 547, 555 (1928); *Southwest Engine Co. v. United States*, 275 F.2d 106, 107 (10th Cir. 1960); *United States v. Roessling*, 280 F.2d 933, 935-936 (5th Cir. 1960); *United States v. Latrobe Construction Co.*, 246 F.2d 357, 364 (8th Cir. 1957).

The "first in time, first in right" rule dates back to 1827.¹¹ The quality of the lien preceding the federal lien was not called into question until more than a hundred years later. Then, in *Spokane County v. United States*,¹² the doctrine of the inchoate and general lien was born. That case held that a federal tax lien defeats a prior lien that is not specific and perfected. In *Spokane*, two counties had assessed taxes against the debtor's personal property, before and after he went into receivership. Upon receivership, the federal lien was accorded priority under the insolvency statute.¹³ The Court emphasized that the counties' liens were not "specific" and "completed" by distraint.¹⁴ The opinion upheld a state court ruling that under Washington law, a county tax lien did not exist until the property had been distressed.

Subsequent decisions siezed upon the requirements of specificity and completion without reference to the state characterization of the lien as non-existent, even though this point was the basis of the Court's decision in *Spokane*. In one case, a lien for franchise taxes on the property of a corporation in receivership was claimed,¹⁶ but these taxes had not been assessed or liquidated until after the receiver had been appointed. Justice Cardozo suggested that the result would have been the same even if the state tax had been liquidated prior to attachment of the federal priority under the insolvency statute, since there had been no change of title or possession. In his words, the lien was but "the lien of a tax not presently enforceable, but serving merely as a *caveat* of a more perfect lien to come,"¹⁷ although under New York law the lien took precedence over prior and subsequent mortgages.¹⁸ Another case extended the doctrine of choateness to a tax lien which was prior to all other existing liens.¹⁹ The Court suggested that prior cases did not require the subordination of unsecured claims of the United States to prior specific and perfected liens.²⁰ Then, in the fact of a state decision that a statutory landlord's lien was choate,²¹ the Court held that it was a matter of federal law whether a lien under state law was sufficiently specific and perfected.²²

Finally, in *Gordon v. Campbell*,²³ the strictness of the doctrine came to full flower. Not only was the test of identity, certainty and definiteness imposed; the Court further suggested that specificity and perfection

¹¹*Bankin v. Scott*, *supra* note 8 at 179.

¹²279 U.S. 80, 93-94 (1929).

¹³31 U.S.C. § 191 (1958). This statute gives priority to tax liens in insolvency cases. *Price v. United States*, 269 U.S. 492 (1926).

¹⁴*Spokane County v. United States*, *supra* note 12 at 94-95.

¹⁵*Exchange National Bank v. United States*, 147 Wash. 176, 265 Pac. 722 (1926).

¹⁶*New York v. Maclay*, 288 U.S. 290 (1933).

¹⁷*Id.* at 294.

¹⁸*New York Terminal Co. v. Gaus*, 204 N.Y. 512, 98 N.E. 11 (1912).

¹⁹*United States v. Texas*, 314 U.S. 480 (1941).

²⁰*Id.* at 486.

²¹*United States v. Waddil, Holland & Flinn, Inc.*, 182 Va. 351, 28 S.E.2d 741, 746 (1944).

²²*United States v. Waddil, Holland & Flinn, Inc.*, 323 U.S. 353, 356-357 (1945).

required a transfer of title or possession.²⁴ In *United States v. Vermont*²⁵ the State of Vermont had imposed a tax lien on the property of a solvent taxpayer, and the United States imposed a similar lien thereafter. Since the assessment had the force of a judgment and subjected the debtor's property to summary seizure to satisfy the debt,²⁶ the lien was held sufficiently choate.

Most of the cases involved in the development of the doctrine of the choate lien involve tax liens or the insolvency statute. The few cases not rising under these statutes are not of significant help in determining whether a different standard of choateness should be applied in the instant case, since they do not turn on questions of competing security interests. For example, *United States v. Yazell*²⁷ turned on a question of the Texas law of coverture. Other cases have involved freight refunds,²⁸ defective chattel mortgages under the Civil Aeronautics Act of 1938,²⁹ and the California bulk sales law.³⁰

The present state of the requirement of choateness³¹ is clearly set forth in *In re Lehigh Valley Mills, Inc.*:³²

The rule of Federal common law is the general equitable principle, "first in time is first in right." *United States v. City of New Britain*, 347 U. S. 81, 85, 74 S. Ct. 367, 370 (1954). That test requires that a lien competing with one of the Federal Government must be choate—*i. e.*, the identity of the lienor, of the property bound by the lien, and of the amount of the lien all must be certain. *United States v. City of New Britain*, *supra* at 84. The last requirement, of course, is only met if there is no further opportunity for judicially contesting the amount of the lien. Thus, the lienor must either have obtained judgment on the lien or it must be enforceable against the property by summary proceeding.³³

It is submitted that the Montana mechanic's lien in the principal case does not meet the test. It cannot be enforced summarily because there must be a trial governed by the code of civil procedure (Title 93).³⁴ In the principal case, the lien had not been reduced to judgment.

The effect of this decision is to hold that the rule of choateness is inapplicable to cases not arising under the insolvency or tax lien statutes, since it rejects cases founded on those statutes,³⁵ and seems to reject the concept of choateness itself.³⁶ The court noted that federal liens do not

²⁴*Id.* at 376. See also *United States v. Gilbert Associates, Inc.*, 354 U.S. 361 (1953).

²⁵377 U.S. 351 (1964).

²⁶*Id.* at 359.

²⁷382 U.S. 341 (1966).

²⁸*United States v. Bethke*, 132 F. Supp. 22 (1955).

²⁹*United States v. United Aircraft Corp.*, 80 F. Supp. 52 (1948).

³⁰*Bumb v. United States*, 276 F.2d 729 (9th Cir. 1960).

³¹See generally Annot., 90 A.L.R.2d 1179, 1181 (1963); 94 A.L.R.2d 748, 781 (1964); 7 L. Ed.2d 904 (1962).

³²*Supra* note 8.

³³*Id.* at 401.

³⁴R.C.M. 1947, §§ 45-507 and 45-508.

³⁵Instant case at 820.

³⁶*Id.* at 821. The rules of choateness set forth in *In Re Lehigh Valley Mills, Inc.*, *supra* meet the requirements of identity of lienor, property, and by the lien and amount of

have any special quality of perfection or priority simply because they are federal, and asked what standard should be fashioned.³⁷ That standard was supplied by the Montana policy of preferring the mechanic's lien over the mortgage,³⁸ and the court declined to establish a federal rule differing from the local rule. The prime consideration thus becomes one of balancing the competing federal policy against the Montana deference to the mechanic's lien.³⁹

The federal policy is "founded not so much upon any personal advantage to the sovereign as upon motives of public policy, in order to secure an adequate revenue to sustain the public burdens and discharge the public debts."⁴⁰ Concern with federal revenue has not since faded, and the policy which moved the court then still has force. Significantly, the language quoted above was substantially repeated in *Spokane County v. United States*,⁴¹ and as has been noted, *Spokane* gave birth to the doctrine of choateness.

The competing policy found early and exact expression in Montana in *Mochon v. Sullivan*,⁴² tried in the Territorial court in 1871:

[The mechanic's lien] is remedial in its character, rests upon the broad foundation of natural equity and commercial necessity.

The doctrine upon which it is founded is upon the consideration of natural justice, that the party who has enhanced the value of property . . . shall have a preferred claim on said property. . . .

This policy was supplemented by the more mundane observation of the court in the instant case that liens and mortgages share equal infirmities in the law, and that the United States can protect itself by ordinary business prudence.⁴³

the lien. The court notes that a mortgage is no more certain than a lien in these respects, since both mortgage and lien are subject to controversy. A footnote continues as to certainty of amount in this language: "The point is that the facts do exist. Any uncertainty lies in the capacity of the court, in the event of a controversy, to determine the pre-existent facts. If this uncertainty is a truth which courts must take into account, it exists quite as well in the mortgage case as any other." Minor lien statutes are not considered in the opinion and are therefore not considered here; see, e.g., INT. REV. CODE OF 1954, § 2800(e) (distilled spirits tax lien).

³⁷Instant case at 821.

³⁸R.C.M. 1947, §§ 45-504 and 45-506, *supra* note 3.

³⁹Instant case at 821. See *Mochon v. Sullivan*, 1 Mont. 470 (1871); *Federal Land Bank v. Green*, 108 Mont. 56, 90 P.2d 489, 491 (1939) (natural equity and commercial necessity); *Smith v. Gunnis*, 115 Mont. 362, 144 P.2d 186, 189 (1943) (providing payment of claims out of the property to which their work and material have contributed an increased value.) The later cases do not discuss the underlying philosophy, but tend to limit their observations to a statement that the law should be liberally construed to effect its purposes and policies. See, e.g., *Leigland v. McGaffick*, 135 Mont. 188, 388 P.2d 1037 (1959).

⁴⁰*United States v. State Bank of North Carolina*, 31 U.S. (6 Pet.) 29, 35 (1832). See also *United States v. New Britain*, *supra* note 8.

⁴¹*Supra* note 12 at 92.

⁴²*Supra* note 39.

⁴³Instant case at 821. The lienholder, on the other hand, is arguably less able to protect himself against a SBA mortgage subsequently made, since presumably he is less well-staffed and less conversant with the details of the law than his competitor. Further, no prudence can guard against a mortgage made invulnerable by the doctrine of

Other cases have approved diversity of rules flowing from the applicability of local laws, as against a uniform federal rule.⁴⁴ *Bumb v. United States*,⁴⁵ cited as apposite in the opinion,⁴⁶ found no reason to impose a uniform federal rule. *Bumb* held that the Small Business Administration, presumably staffed by competent personnel familiar with the laws of the states where it does business, can acquire valid security interests in the various states. The transaction, local in nature, should accord with sound and well-established local policies.⁴⁷ Justice Fortas could find no overriding federal interest which would justify overturning the Texas coverture law in favor of the SBA in *United States v. Yazell*,⁴⁸ and noted *Bumb* with approval.

The result of this case, as in all cases involving choices among valid and reasonable policies, will be welcomed or deplored according to the philosophy of the reader. It is submitted that the result in favor of mechanic's liens is correct. Choateness has been a tool for appropriating the benefit of the mechanic's labor and materials to the government, leaving the artisan with only the surplus after the sovereign's share is taken. The doctrine has been so strict as to nullify the historical security of the artisan against the world. On the other hand, the rule of this case, within the limits of the decision, does not portend disaster for the SBA. It may require the SBA to use ordinary business prudence, but it for that agency to argue whether that is a detriment.

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TORTS—MALPRACTICE—STATUTE OF LIMITATIONS RUNS FROM DATE OF DISCOVERY NOT FROM DATE OF NEGLIGENT ACT.—In a medical malpractice action brought ten years after an operation, plaintiff alleged that the defendant surgeon negligently left a surgical sponge in plaintiff's hip. Defendant's motion for summary judgment was granted, the trial court holding the action was barred by the statute of limitations.¹ On appeal, *held*, reversed. The statute of limitations did not commence running until the plaintiff discovered or reasonably should have discovered the presence of the foreign object. *Johnson v. St. Patrick's Hospital*, 23 State Rep. 581, 417 P.2d 469 (Mont. 1966).

Statutes of limitation generally are held to be statutes of repose

⁴⁴*Bumb v. United States*, *supra* note 30; *United States v. Yazell*, 382 U.S. 341, 347 (1966).

⁴⁵*Ibid.*

⁴⁶Instant case at 821.

⁴⁷*Supra* note 44.

⁴⁸*Supra* note 44 at 347.