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## Bankruptcy—Recorded Statutory Lien for Unpaid California Income Taxes Insufficiently Perfected to Encompass Personal Property—Invalidity as against the Trustee—In Re Perry

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**BANKRUPTCY—RECORDED STATUTORY LIEN FOR UNPAID CALIFORNIA INCOME TAXES INSUFFICIENTLY PERFECTED TO ENCOMPASS PERSONAL PROPERTY—INVALIDITY AS AGAINST THE TRUSTEE—*In re Perry*, 487 F.2d 84 (9th Cir. 1973), cert. denied, 415 U.S. 978 (1974).**

The question of priority in bankruptcy of a recorded California tax lien was recently decided by the Court of Appeals for the Ninth Circuit in *In re Perry*.<sup>1</sup> In so doing, the court added some clarification to the ambiguous area surrounding the interrelationship between federal and state law. Generally, in bankruptcy proceedings the trustee in bankruptcy takes the bankrupt's estate subject to existing statutory liens, as required by section 67b of the Bankruptcy Act.<sup>2</sup> These liens must be satisfied even before the costs of administration of the bankruptcy are paid. However, section 67c<sup>3</sup> qualifies this priority in several ways. Subsection (1)(B) of section 67c<sup>4</sup> requires that statutory liens<sup>5</sup> be

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1. 487 F.2d 84 (1973), cert. denied, 415 U.S. 978 (1974). The question considered in *In re Perry* was raised in *Schriber v. Alameda County-East Bay Title Ins. Co.*, 156 Cal. App. 2d 700, 320 P.2d 82 (1958). The court expressly left undecided the issue of whether section 18882 of the Revenue and Taxation Code (see text accompanying note 14 *infra*) creates a lien "broader than the ordinary judgment lien" by its language making the lien attach to all property of the taxpayer within the county. *Id.* at 707, 320 P.2d at 86-87.

2. 11 U.S.C. § 107(b) (1970), which provides:

(b) The provisions of section 96 of this title to the contrary notwithstanding and except as otherwise provided in subdivision (c) of this section, statutory liens in favor of employees, contractors, mechanics, or any other class of persons, and statutory liens for taxes and debts owing to the United States or to any State or any subdivision thereof, created or recognized by the laws of the United States or any State, may be valid against the trustee, even though arising or perfected while the debtor is insolvent and within four months prior to the filing of the petition initiating a proceeding under this title by or against him.

3. 11 U.S.C. § 107(c) (1970).

4. 11 U.S.C. § 107(c)(1)(B) (1970). The following liens shall be invalid against the trustee:

(B) every statutory lien which is not perfected or enforceable at the date of bankruptcy against one acquiring the rights of a bona fide purchaser from the debtor on that date, whether or not such purchaser exists: *Provided*, That where a statutory lien is not invalid at the date of bankruptcy against the trustee under subdivision (c) of section 110 of this title and is required by applicable lien law to be perfected in order to be valid against a subsequent bona fide purchaser, such a lien may nevertheless be valid under this subdivision if perfected within the time permitted by and in accordance with the requirements of such law: *And provided further*, That if applicable lien law requires a lien valid against the trustee under section 110(c) of this title to be perfected by the seizure of property, it shall instead be perfected as permitted by this subdivision by filing notice thereof with the court . . . .

5. "Statutory lien" is defined by Bankruptcy Act § 1(29a), 11 U.S.C. § 1(29a) (1970):

Statutory lien shall mean a lien arising solely by force of statute upon specified circumstances or conditions, but shall not include any lien provided by or de-

“perfected or enforceable at the date of bankruptcy against one acquiring the rights of a bona fide purchaser from the debtor on that date, whether or not such purchaser exists,”<sup>6</sup> in order to avoid invalidity as to the trustee. Moreover, subsection (3) of section 67c<sup>7</sup> postpones payment of a statutory tax lien, otherwise valid under section 67c (1)(B), on *personal* property not accompanied by possession until the costs of administration of the bankruptcy and the wages and commissions have been paid.<sup>8</sup> Should a tax lien not be valid under subsection (1)(B) of section 67c, then subsection (2) of section 67c<sup>9</sup> comes into effect and reduces the tax lien from a secured to a fourth level priority position or to the position of a general unsecured claims.<sup>10</sup>

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pendent upon an agreement to give security, whether or not such lien is also provided by or is also dependent upon statute and whether or not the agreement or lien is made fully effective by statute.

6. See note 4 *supra*.

7. 11 U.S.C. § 107(c)(3) (1970), which provides:

(3) Every tax lien on personal property not accompanied by possession shall be postponed in payment to the debts specified in clauses (1) and (2) of subdivision (a) of section 104 of this title. Where such a tax lien is prior in right to liens indefeasible in bankruptcy, the court shall order payment from the proceeds derived from the sale of the personal property to which the tax lien attaches, less the actual costs of that sale, of an amount not in excess of the tax lien, to the debts specified in clauses (1) and (2) of subdivision (a) of section 104 of this title. If the amount realized from the sale exceeds the total of such debts, after allowing for prior indefeasible liens and the cost of the sale, the excess up to the amount of the difference between the total paid to the debts specified in clauses (1) and (2) of subdivision (a) of section 104 of this title and the amount of the tax lien, is to be paid to the holder of the tax lien.

8. *Id.* Bankruptcy Act § 64a (1) & (2), 11 U.S.C. § 104(a)(1) & (2) (1970), refers to (1) costs of administration of bankruptcy and (2) wages and commissions claimed, respectively.

9. 11 U.S.C. § 107(c)(2) (1970), which provides:

(2) The Court may, on due notice, order any of the aforesaid liens invalidated against the trustee to be preserved for the benefit of the estate and in that event the lien shall pass to the trustee. A lien not preserved for the benefit of the estate but invalidated against the trustee shall be invalid as against all liens indefeasible in bankruptcy, so as to have the effect of promoting liens indefeasible in bankruptcy which would otherwise be subordinate to such invalidated lien. Claims for wages, taxes, and rent secured by liens hereby invalidated or preserved shall be respectively allowable with priority and restricted as are debts therefor entitled to priority under clauses (2), (4), and (5) of subdivision (a) of section 104 of this title, even though not otherwise granted priority.

Section 64a of the Bankruptcy Act, 11 U.S.C. § 104(a), provides the following priority:

- (1) the costs and expenses of administration;
- (2) wages and commissions;
- (3) costs and expenses of creditors proceeding under Chapter 9, Title 18, United States Code;
- (4) taxes due the United States, any State or subdivision thereof.

10. 4 COLLIER ON BANKRUPTCY 408-11 (14th ed. J. Moore ed. 1971). Generally, a “lien” or a “secured” interest is a right a person has against property of another to insure the payment of a debt or charge. All secured interests must be satisfied before priority creditors share in the distribution of the bankruptcy estate. This should be distinguished from “priority” claims. Priority refers to an unsecured and

In *Perry*, the bankrupt failed to pay state personal income taxes for 1962, and the California Franchise Tax Board (FTB), in order to perfect its outstanding claim, recorded a tax certificate with the Los Angeles County Recorder in December, 1966, approximately two-and-one-half months before the bankruptcy petition was filed.<sup>11</sup> This recordation of the tax certificate constituted a lien under section 18882 of the California Revenue and Taxation Code<sup>12</sup>:

From the time of the filing for recording the amount of the tax, interest, and penalty<sup>13</sup> set forth constitutes a lien upon *all property* of the taxpayer in the county, owned by him or afterward and before the lien expires acquired by him. *The lien has the force, effect, and priority of a judgment lien* and continues for 10 years from the date of the recording unless sooner released or otherwise discharged.<sup>14</sup>

Since there was no real property on which the lien could be discharged,<sup>15</sup> the FTB sought to establish an enforceable lien against the bankrupt's personal property under section 67c (3).

As initially considered, the question of the priority of the state's tax lien was summarily disposed of by the referee in his ruling that Cal-

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general charge against the bankrupt's estate, but because of legislation reflecting some public policy, the claim is favored over others. The end result of this is that the priority claim must be satisfied before the other unsecured claims. Within the confines of the priority structure, there are different levels, a first level priority taking precedence over a second level priority and so forth. *See, e.g., C. NADLER, THE LAW OF BANKRUPTCY* 150-53 (2d ed. S. Nadler & M. Nadler eds. 1965).

The distinction is often critical for the bankrupt subject to tax claims. If the tax lien is reduced from a secured position to a priority position, the assets of the bankrupt's estate may be insufficient to satisfy the tax claim. Since a tax obligation is not generally discharged in bankruptcy, the reduction of the tax lien can often result in the bankrupt owing substantial tax obligations after bankruptcy.

11. Normally taxes which became due more than three years prior to the bankruptcy are dischargeable in bankruptcy. Bankruptcy Act § 17(1), 11 U.S.C. § 35(a)(1) (1970). However, there are numerous exceptions to this rule, one of which provides that taxes are not a debt affected by a discharge if the taxes "were assessed within one year preceeding bankruptcy in any case in which the bankrupt failed to make a return required by law." *Id.*, subsection (b).

12. CAL. REV. & TAX CODE ANN. § 18882 (West Supp. 1974).

13. Debts owed to the State as a penalty are not allowed. Bankruptcy Act § 57(j), 11 U.S.C. 93(j) (1970); *Simonson v. Granquist*, 369 U.S. 38 (1962). Thus the penalty portion of Section 18882, although incorporated as part of the state tax lien, is not allowable. However, it is apparently not discharged and is still owed by the bankrupt. *See* Bankruptcy Act § 17(a)(1), 11 U.S.C. § 35(1) (1970).

14. CAL. REV. & TAX. CODE ANN. § 18882 (West Supp. 1974) (emphasis added).

15. If the bankrupt had owned real property, the tax lien would have been secured and preceded priority distributions. *See* 4 COLLIER ON BANKRUPTCY 374-76 (14th ed. J. Moore ed. 1971).

ifornia Revenue and Taxation Code section 18882,<sup>16</sup> in its use of the language "judgment lien," limited the lien to real property;<sup>17</sup> thus, the FTB's claim against the personal property was denied a section 67c (3) position.<sup>18</sup> The referee further noted that the California Legislature, by enacting section 18882.5 in 1969 (after the filing of Perry's petition in bankruptcy), expressly extended the lien to cover personal property, but only upon the filing of a certificate of the state tax lien. This negated any inference that section 18882 applied to anything other than real property. The referee's findings were summarily affirmed by the district court.<sup>19</sup>

Since there were no previous state court decisions interpreting section 18882, the *Perry* court had to determine, first, if the section applied to both real and personal property, and, second, if the lien was valid against the trustee under section 67c(1)(B).<sup>20</sup> As for the first of these determinations, the court unanimously agreed that the "all property" language of section 18882<sup>21</sup> included both real and personal property.<sup>22</sup> This result was reached by an examination of the legislative history<sup>23</sup> of section 18882 and by comparing it with similar code enactments for delinquent sales and use taxes (California Revenue and Taxation Code section 6757<sup>24</sup>) and for unpaid unemployment insurance contributions (California Unemployment Insurance Code section 1703<sup>25</sup>). Prior to 1957, both sections 6757 and 1703 provided for liens against "real" property only; the 1957 amendments changed that to include "all property."<sup>26</sup> The court therefore concluded that the "all

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16. See note 3 *supra*.

17. In California, a judgment lien attaches only to real property. CAL. CODE CIV. PRO. § 674 (West 1967); *see, e.g.*, *Miller v. Bank of America*, 166 F.2d 415 (9th Cir. 1948); *Arnett v. Peterson*, 15 Cal. App. 3d 110, 92 Cal. Rptr. 913 (1971); *Balzano v. Traeger*, 93 Cal. App. 640, 270 P. 248 (1928); *Finch v. Finch*, 68 Cal. App. 72, 228 P. 553 (1924).

18. See note 4 *supra* and accompanying text.

19. 487 F.2d at 87.

20. See note 4 *supra* and accompanying text.

21. See text accompanying note 12 *supra*.

22. 487 F.2d at 85, 88.

23. *Id.* at 85-88.

24. CAL. REV. & TAX. CODE ANN. § 6757 (West 1970).

25. CAL. UNEMP. INS. CODE ANN. § 1703 (West 1972).

26. Ch. 863, § 2, [1965] Cal. Stat. 2464, amending ch. 57, § 14, [1935] Cal. Stat. 1262 (codified at CAL. REV. & TAX. CODE ANN. § 6757 (West 1970)); ch. 1188, § 2, [1957] Cal. Stat. 2479, amending ch. 566, § 2, [1945] Cal. Stat. 1103 (codified at CAL. UNEMP. INS. CODE ANN. § 1703 (West 1972)). Judge Zirpoli further argued that the inclusion of personal property into the interpretation of "all property" was consistent with Revenue and Taxation Code section 103, CAL. REV. & TAX. CODE ANN. § 103 (West

property" provision of section 18882 should be similarly construed to apply to both real and personal property.<sup>27</sup>

The second question—the validity of the lien against personal property—presented a more difficult problem. Section 18882 provides that "[t]he lien has the force, effect, and priority of a judgment lien."<sup>28</sup> In California, since judgment liens *attach* only to real property, they are valid only as against bona fide purchasers of real, and not personal, property. To avoid this result, the FTB attempted to show that the legislative history indicated that the filing procedure set forth in section 18882 would create a lien valid against a bona fide purchaser of both real and personal property.<sup>29</sup>

In 1969, section 18882.5 was added to the California Revenue and Taxation Code.<sup>30</sup> This section provides:

The board may also file a certificate of state tax lien with the Secretary of State . . . . From the time of the filing of the certificate with the Secretary of State, the amount required to be paid, together with interest and penalty constitutes a lien upon all personal property in the state owned by the person or afterwards acquired by him until the certificate of state tax lien lapses. The lien has the force, effect and priority of a judgment lien.<sup>31</sup>

Section 1703 of the California Unemployment Insurance Code and section 6757 of the California Revenue and Taxation Code, and their more recently adopted counterparts, sections 1703.5 and 6757.5, also contain similar provisions.<sup>32</sup> However, these sections also have the additional proviso that the lien imposed shall not be valid "as against a purchaser for value without actual knowledge of the lien." The FTB contended

[t]hat the exceptions in the sales and use tax and in the unemployment compensation tax sections indicate that the legislature believed that, without them, the liens would be good against *bona fide* purchasers of personal property, and that the absence of such an exception in §§ 18882 and 18882.5 indicates that the liens under those sections were

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1970), in which the definition of property is stated as "all matters and things, real, personal, and mixed, capable of private ownership."

27. 487 F.2d at 86.

28. CAL. REV. & TAX. CODE ANN. § 18882 (West Supp. 1974).

29. 487 F.2d at 86.

30. CAL. REV. & TAX. CODE ANN. § 18882.5 (West Supp. 1974).

31. *Id.*

32. See notes 24 & 25 *supra* and accompanying text.

meant to be, and are, good against *bona fide* purchasers of personal property.<sup>33</sup>

The majority, disagreeing with the FTB's contention, concluded that the legislature's characterization of the lien as a "judgment lien" was controlling. Since a judgment lien is not enforceable against a bona fide purchaser of personal property, it was invalid against the trustee under 67c (1)(B). Thus, the FTB's status was reduced from a postponed secured lien to a general unsecured claim (since the tax lien did not qualify for fourth level priority under section 64a (4)<sup>34</sup>).

Judge Zirpoli, in his dissent, agreed with the FTB's contention that the omission of the proviso exempting personal property from being subject to the lien evidenced the legislative intent to make the section 18882 lien valid against a bona fide purchaser of personal property upon recordation and thus was enforceable against the trustee. In furtherance of his contention that section 18882 operated to perfect the tax lien on personal property, Judge Zirpoli, in making reference to the majority's contention that perfection of the lien demanded the levying of a writ of execution (the mere recordation of the lien pursuant to section 18882 not being sufficient), was quick to emphasize that, in California, a judgment lien can never attach to personal property.<sup>35</sup> Thus, to construe the phrase, "[t]he lien has the force, effect, and priority of a judgment lien" as indicative of a legislative intent to impose the characteristics of a judgment lien while at the same time requiring the levying of a writ of execution in order that the lien be valid, obliterates the well-grounded distinction between an execution lien and a judgment lien:

Only by erroneously considering an execution lien to be the same thing as a judgment lien is it possible to argue that Section 18882 creates a lien that is perfected as against a bona fide purchaser of personal property by levying a writ of execution: Section 18882 creates a lien with the same characteristics as a judgment lien and a judgment lien is always perfected under California law by filing. It is a California execution lien that is perfected by levying a writ of execution.<sup>36</sup>

According to Judge Zirpoli's interpretation of section 18882, perfection which is sufficient under section 67c (1)(B) of the Bankruptcy Act<sup>37</sup> is attained by the mere recordation of the lien.

33. 487 F.2d at 86.

34. *Id.* at 87; 11 U.S.C. § 104(a) (1970).

35. *Id.* at 88-89.

36. *Id.* at 89. *But see* Wayland v. State, 161 Cal. App. 2d 679, 326 P.2d 954 (1958).

37. *See* note 4 *supra*.

The legislative history behind the amendments to the Bankruptcy Act illustrates the federal policy of insuring "the supremacy of the order of distribution provided in the Bankruptcy Act insofar as it is consistent with the continued recognition of genuine lien interests . . . ."<sup>38</sup> While federal bankruptcy law determines the position in distribution of the lien, the validity of the lien is determined by state law, in this case section 18882.<sup>39</sup> The *Perry* court, interpreting this unclear state statute, determined that additional steps were required to perfect the lien "against one acquiring the rights of a bona fide purchaser . . . ."<sup>40</sup> Potentially, the California courts could conclude that the provisions of section 18882 *do* create an enforceable lien on personal property. Under such analysis, 67c would require the lien to be given a secured, although postponed, position in the bankruptcy distribution, a result in direct conflict to the *Perry* holding. Thus, the continuing validity of *Perry* will depend upon California's acceptance or rejection of the federal court's interpretation of the section 18882 statutory lien.

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38. 2 U.S. CODE CONG. & AD. NEWS, 89th Cong., 2d Sess. 2461 (1966).

39. See notes 2-10 *supra* and accompanying text.

40. 11 U.S.C. § 107(c)(1)(b) (1970). On petition for rehearing, the FTB claimed that its lien came within the second proviso of section 67c (1)(B). See note 4 *supra*. The second proviso provides that if the applicable lien law requires a lien valid against the trustee under section 70c (11 U.S.C. § 110 (c) (1970)) to be perfected by seizure, it can be perfected after the date of bankruptcy by filing notification with the court. See *In re J.R. Nieves & Co.*, 446 F.2d 188, 193 (1st Cir. 1971). The court, in denying rehearing, concluded that the lien was not valid against a judgment creditor at the date of bankruptcy (487 F.2d at 89), that state law, although providing seizure as a means of enforcing the lien, did not require seizure to perfect the lien (*id.*, citing *In re J.R. Nieves & Co.*, 446 F.2d 188, 194 (1st Cir. 1971); see CAL. REV. & TAX. CODE ANN. §§ 18906-07 (West 1970)), and that the FTB did not file the appropriate notification with the court (487 F.2d at 89-90). The preservation after the date of bankruptcy of a state tax lien unperfected as against a bona fide purchaser on the date of bankruptcy remains an area of considerable confusion. See, e.g., Marsh, *Triumph or Tragedy? The Bankruptcy Act Amendments of 1966*, 42 WASH. L. REV. 681, 721-23 (1967).