United States Bankruptcy Court
Western District of Wisconsin

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In re David E. Black and Mary Joan Black, Debtors
Bankruptcy Case No. 91-33395-11

United States Bankruptcy Court
W.D. Wisconsin

July 12, 1993

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Robert D. Martin, United States Bankruptcy Judge.

MEMORANDUM DECISION

David and Mary Black ("debtors") are farmers who live in Green County, Wisconsin. The debtors run a hog operation which, prior to 1992, had locations in Green and Lafayette Counties, Wisconsin. The hog operation involves raising feeder pigs, which are pigs aging 0 to 2½ months and weighing 60 pounds or less. All pigs born as a part of the debtors' hog operation are born in Lafayette County and remain there until they weigh approximately 40 pounds. Then they are either sold or transferred to the debtors' farm in Green County to be "finished," a process which takes approximately 4-4½ months. As of January 13, 1993, all feeder pigs owned by the debtors were located at the debtors' facilities in Lafayette County.

On January 24, 1978, the debtors entered into a security agreement with Production Credit Association ("PCA"). On May 30, 1980, the debtors entered into a second security agreement with PCA. The 1980 security agreement was amended on April 15, 1985, and March 22, 1989. The agreements granted PCA security interests in, inter alia, "all livestock now owned or hereafter acquired by Debtor, and the young of all livestock" and "all livestock and poultry and the young of such livestock and poultry." Financing statements describing the collateral as "all Livestock & young thereof" and "[a]ll now owned and hereafter acquired: . . . livestock" were filed and continued with the Register of Deeds Office in Green County and Lafayette County.

Sometime prior to September, 1989, the IRS assessed delinquent taxes against the debtors. On September 13, 1989, the Internal Revenue Service ("IRS") filed two notices of federal tax lien in Green County, claiming a security interest in the debtors' property.

The debtors filed a petition for relief under Chapter 11 of the Bankruptcy Code on October 15, 1991. This court confirmed the debtors' second amended plan of liquidation on November 16, 1992. Paragraph 6.5 of the confirmed plan provides for the sale of all nonexempt livestock in March, 1993.(1)

The IRS and PCA agree that PCA holds the first lien position on all personal property and animals, except the feeder pigs.[(2)] The parties dispute, however, the priority of their respective liens against the feeder pigs. The parties do not dispute the relevant facts and have submitted briefs in support of their positions.

Because the feeder pigs did not exist at the time of the filing of the notices of federal tax lien or within 45 days thereafter, the IRS has priority over PCA with respect to the feeder pigs.

A lien in favor of the IRS for unpaid taxes, interest, and penalties arises upon demand on all real and personal property of the taxpayer. 26 USC § 6321. The lien arises at the time an assessment is made and continues until the liability is satisfied or becomes unenforceable by lapse of time. 26 USC § 6322. The lien attaches to all property interests held by a taxpayer on the date of assessment and all property interests subsequently acquired by the taxpayer while the lien is in force. Glass City Bank v United States, 326 US 265 (1945); J.D. Court, Inc. v United States, 712 F2d 258, 260-261 (7th Cir 1983), cert. denied 466 US 927 (1984). Accordingly, a lien on the debtors' property in favor of the IRS arose upon assessment made sometime prior to September, 1989.

The parties do not dispute that, under the Uniform Commercial Code ("UCC"), enacted in Wisconsin as Wis.Stat. § 409.101 et seq., PCA has a perfected security interest in the debtors' livestock. Where, as here, one of the liens is a federal tax lien, the priority of competing liens is an issue of federal law. Aquilino v United States, 363 US 509, 513-514 (1960). Pursuant to § 6323(a), a lien imposed by § 6321 is not valid against a holder of a security interest until proper notice of the federal tax lien is given. 26 USC § 6323(a). An exception to this general priority rule is found in § 6323(c),[(3)] which creates a 45-day "safe harbor" for certain advances made or collateral added after the filing of the tax lien notices.

Section 6323(a) incorporates the principle governing priority between competing liens that "first in time is first in right." See Rice Inv. Co. v United States, 625 F2d 565, 568 (5th Cir 1980). However, when a federal tax lien is involved, the Supreme Court has added to this principle the requirement that to be "first in time," the nonfederal lien must first have become "choate." Id. (citing United States v City of New Britain, 347 US 81 (1954)). The doctrine of choateness requires that the identity of the lienor, the property subject to the lien and the amount of the lien be established beyond any possibility of change or dispute. Rice Inv. Co., 625 F2d at 568. Whether a lien is choate is a matter of federal law. Id. (citing United States v Pioneer Amer. Ins. Co., 374 US 84 (1963)).

Still debated is whether the enactment of the Federal Tax Lien Act of 1966 ("FTLA"), which substantially amended § 6323, abrogated the choateness doctrine. See Jersey State Bank v United States, 926 F2d 621, 623-624 (7th Cir 1991). The FTLA was, in part, "an attempt to conform the lien provisions of the internal revenue laws to the concepts developed in [the] Uniform Commercial Code." In re National Financial Alternatives, Inc., 96 BR 844, 850 (Bankr ND Ill 1989) (quoting SRep No 1708, 89th Cong, 2d Sess, reprinted in 1966 USCode Cong & Admin News 3722)). At least one decision has thus interpreted the FTLA to replace the choateness doctrine. See Aetna Ins. Co. v Texas Thermal Industries, Inc., 591 F2d 1035, 1038 (5th Cir 1979).

Nonetheless, the Seventh Circuit continues to recognize the viability of the choateness doctrine subsequent to the enactment of the FTLA. In J.D. Court, Inc. v United States, 712 F2d 258, 263 (7th Cir 1983), cert. denied 466 US 927 (1984), the Seventh Circuit concluded that the choateness doctrine is a valid legal principle in determining the priority between a federal tax lien and a state law security interest. Specifically, the court found that the commercial creditor's security interest in the debtor's accounts

receivable became "choate," and therefore "attached," only when the accounts came into existence, that is, at the time the services giving rise to the accounts receivable were performed. Id. at 263. Consequently, the commercial creditor had priority over the IRS only to those accounts receivable arising prior to the government's filing of its notice of tax lien, or within 45 days thereafter as provided under 26 USC § 6323(c). Id. at 264. See also Sgro v United States, 609 F2d 1259 (7th Cir 1979); Asher v United States, 570 F2d 682 (7th Cir 1978).

More recently and in dicta, the Seventh Circuit has expressed doubt that the choateness doctrine survived the enactment of the FTLA. In Jersey State Bank v United States, 926 F2d 621 (7th Cir 1991), Judge Posner observed:

The 1966 Act, passed as it was in part to alleviate the perceived harshness of the doctrine of inchoate liens, . . . is markedly, perhaps pregnantly, silent in regard to any requirement that the state tax lien be "choate"; all that is required is that the state security interest have been obtained prior to the filing of the federal tax lien. And the Committee reports state that security interests as defined in the Act "are to have a priority over a nonfiled Federal tax lien . . . whether or not in all other regards they are definite and complete at the time notice of the tax lien is filed." . . . Aetna [Ins. Co. v Texas Thermal Industries, Inc., 591 F2d 1035 (5th Cir 1979)] concluded that the Tax Lien Act had wiped out the doctrine of inchoate liens. A number of other decisions, however, including our own J.D. Court, Inc. v United States, 712 F2d 258, 262 (7th Cir 1983), and decisions in the Fifth Circuit itself . . . disagree . . . . The present case is hardly the one in which to try to resolve the question what if anything of the doctrine of inchoate liens survived the passage of the Tax Lien Act.

Id. at 623-624 (citations omitted). Yet, despite the uncertainty surrounding the choateness doctrine, the Supreme Court very recently acknowledged its continued viability in cases involving § 6323. See United States v McDermott, -- US --, 113 SCt 1526 (1993) ("our cases deem a competing state lien to be in existence for 'first in time' purposes only when it has been 'perfected' in the sense that 'the identity of the lienor, the property subject to the lien, and the amount of the lien are established'") (emphasis in original) (quoting United States v New Britain, 347 US 81, 84 (1954); United States v Pioneer American Ins. Co., 374 US 84 (1963)).

Although not clear from the statute, its legislative history,[(4)] or the subsequent case law,[(5)] the definition of "security interest" under § 6323(h)(1) may codify the choateness doctrine:

The term "security interest" means any interest in property acquired by contract for the purpose of securing payment or performance of an obligation or indemnifying against loss or liability. A security interest exists at any time (A) if, at such time, the property is in existence and the interest has become protected under local law against a subsequent judgment lien arising out of an unsecured obligation, and (B) to the extent that, at such time, the holder has parted with money or money's worth.

26 USC § 6323(h)(1) (emphasis added). According to one authority:

One of the current debates concerns whether the requirement of existence under section 6323(h) should be defined in terms of the wording of that provision or the broader choateness doctrine of the federal tax lien case law. . . . under either the wording of section 6323(h) or the choateness doctrine, it is clear that Article 9 floating liens cannot establish their priority under the "normal" priority rule of subsections (a) and (h) of section 6323 with respect to collateral acquired by the debtor after the tax lien is filed. This after-acquired property interest does not exist and is not choate as of the crucial date--the day the tax lien is filed.

1A Secured Transactions under the U.C.C., § 7F.02 at 7F-5 (Matthew Bender 1993) (footnotes omitted). Elsewhere the authors observe:

Under Section 9-204, there can be no U.C.C. security interest in property if the debtor at the time of its purported creation has no rights therein. It would seem that section 6323(h)(1) is trying to say the same thing in the words "property is in existence." However, the implications of insisting on rights in collateral or property in existence is different in the two statutory schemes. Under Article 9 the secured creditor's priority over other secured creditors and lien creditors is regularly fixed as of the time the creditor files its financing statement even if the debtor acquires rights in collateral at a later time. But under the tax lien scheme the property must be in existence as property of the taxpayer before the tax lien filing in order for the creditor to prevail under section 6323(a).

Id. § 7F.06[1] at 7F-29 (footnotes omitted).

In the present case, the parties do not dispute that PCA's interest was acquired by contract to secure payment of an obligation to it and that its interest was protected under local law against a subsequent judgment lien. However, the IRS contends that, because the feeder pigs to be sold in March, 1993, were not "property in existence" on either the date of the filing of the IRS notices of tax lien or within the 45-day safe harbor period provided under § 6323(c), PCA does not have a prior lien in the feeder pigs.

Applying either the choateness doctrine or § 6323(h)(1), the IRS prevails in this case. To have priority over the IRS, the PCA's interest in the feeder pigs must have become choate before the IRS filed its notices of tax lien on September 13, 1989 or within 45 days thereafter. Under the choateness test, three elements must be satisfied: the identity of the lienor, the property subject to the lien, and the amount of the lien must be established. If a feeder pig by definition is 0-2½ months old, the feeder pigs to be sold on March 1, 1993 were born on or after December 15, 1992. Thus, the property subject to PCA's lien was not sufficiently choate before the tax lien filing date or 45 days thereafter. See United States v McDermott, -- US --, 113 SCt 1526, 1529-1530 (1993) (to be choate, property subject to lien must have been acquired by debtor such that security interest in property "attached"). Likewise, the feeder pigs did not constitute "property in existence" on the relevant date. In its reply brief, PCA concedes that the feeder pigs were not born before October 28, 1989, the 45th day after the notices of tax lien were filed.

As stated above, § 6323(c) provides limited protection for certain inchoate liens on secured property. See Sgro v United States, 609 F2d 1259, 1261 (7th Cir 1979). To fall within this narrow exception to the "first in time, first in right" rule, the agreement must constitute a "commercial transactions financing agreement."(6) The security must constitute "commercial financial security" defined as "(i) paper of a kind ordinarily arising in commercial transactions, (ii) accounts receivable, (iii) mortgages on real property, and (iv) inventory." 26 USC § 6323(c)(2)(C). The exception is limited to commercial financing security acquired by the taxpayer before the 46th day after the date of the tax lien filing. 26 USC § 6323(c)(2)(B).

The IRS does not dispute that PCA's security interest is a commercial transactions financing agreement.(7) Instead, it contends that the safe harbor created by § 6323(c) does not extend to PCA's lien in the feeder pigs because the feeder pigs came into existence after the 46th day after the date the notices of tax lien were filed. PCA concedes that the feeder pigs did not exist within the relevant time period, but argues that they represent identifiable proceeds from sows which did exist at that time.

Assuming, arguendo, that PCA's security interest constitutes a commercial transactions

financing agreement, it must be determined whether § 6323(c) applies to proceeds of "qualified property." In In re National Financial Alternatives, Inc., 96 BR 844, 845 (Bankr ND Ill 1989), the court concluded that accounts receivable acquired more than 45 days after the filing of a notice of tax lien may be considered proceeds of contract rights or inventory acquired prior to the expiration of the 45-day period, so that the security interest of a commercial creditor had priority over the tax lien. Noting that § 6323(c) is silent as to whether security interests in the proceeds of "qualified property" are protected against previously filed tax liens, the court examined the Treasury regulation which provides:

Identifiable proceeds, which arise from the collection or disposition of qualified property by the taxpayer, are considered to be acquired at the time such qualified property is acquired if the secured party has a continuously perfected security interest in the proceeds under local law. The term "proceeds" includes whatever is received when collateral is sold, exchanged, or collected. For purposes of this paragraph, the term "identifiable proceeds" does not include money, checks and the like which have been commingled with other cash proceeds. Property acquired by the taxpayer after the 45th day following tax lien filing, by the expenditure of proceeds, is not qualified property.

Id. at 851 (quoting 26 CFR § 301.6323(c)-1(d).

Similarly, in Walker v United States, 636 FSupp 61, 62 (ND Okl 1986), a bank held the first lien position in the debtor's inventory, after-acquired inventory, accounts receivable and proceeds therefrom. The IRS attempted to recover from the bank monies the bank had received from accounts receivable generated more than 45 days after the IRS filed its notice of lien. The court denied recovery of the portion of those receivables which represented the identifiable proceeds from the disposition of inventory owned by the debtor on the 45th day after the filing of the notice of lien. Id. at 63. PCA argues that, just as the receivables in Walker represented identifiable proceeds from inventory and work in process in which the bank had a prior lien, the feeder pigs are the identifiable proceeds from the debtors' sows in which PCA has a prior lien.

However, while § 6323(c) may apply to proceeds of qualified property, offspring of livestock do not constitute "proceeds" of livestock as that term is understood under the applicable Treasury regulation. Under the regulation, proceeds are "whatever is received when collateral is sold, exchanged, or collected." 26 CFR § 301.6323(c)-1(d). This definition closely resembles the definition of proceeds under the UCC.(8) Both definitions require the disposition or collection of collateral. Nothing in the record suggests that the feeder pigs in dispute represent animals acquired from a disposition of collateral. On the contrary, the feeder pigs represent natural increases of secured livestock. As such, they are not proceeds of that livestock.(9)

PCA's security agreements and financing statements specifically refer to "the young of all livestock" or "all livestock now owned or hereafter acquired." Commentators note that either a specific reference to offspring or increases, or an after-acquired property clause generally covers livestock acquired by natural increase. See Clark, The Agricultural Transaction: Livestock Financing, 11 UCCLJ 106 (1978) ("[i]n general, a security agreement and financing statement covering 'all livestock now owned or hereafter acquired by debtor' would be sufficient to describe livestock presently owned, as well as those later acquired by natural increase, in exchange for culled animals, or from other purchases"); 1D Secured Transactions under the U.C.C., § 27.06[2] at 27-64 (Matthew Bender 1993) ("[w]hile an after-acquired property clause may reach the offspring of livestock, it would seem that if a creditor specifically desires to obtain a security interest in progeny of secured livestock, that specific language could be included to accomplish the result"). See also Fairview State Bank v Edwards, 3

UCCRS2d 1676, 1681, 793 P2d 994, 997 (Okla Supreme Ct 1987) ("[a]s the debtor acquires new livestock by birth or purchase, the after-acquired clause automatically covers these additions").

Because the feeder pigs were not "acquired" within the 45-day period under § 6323(c), PCA's lien in the feeder pigs does not have priority over the federal tax lien. In Rice Inv. Co. v United States, 625 F2d 565, 567 (5th Cir 1980), a creditor had a perfected security interest in all of the debtor's inventory then owned or thereafter acquired. Subsequently, the IRS filed its notice of federal tax lien and levied upon the debtor's inventory. Because the creditor could not determine the date on which the debtor acquired the inventory seized by the IRS, the creditor failed to prove that the inventory was property acquired by the debtor before the 46th day after the filing of the tax lien notice. Id. at 571. The court further rejected the creditor's argument that the "in existence" language in the definition of "security interest" should cover not only the debtor's inventory in existence on the date of the filing of the tax lien, but also any inventory which thereafter replaced such inventory. Id. at 572. The court stated: "[t]o accept [the creditor's] argument, however, would be . . . to ignore the legislative history of the Federal Tax Lien Act of 1966 which evidences a clear intent not to give commercial lenders an infinite priority over the United States, but instead to limit such lenders to property acquired by the taxpayer debtor before the 46th day after the filing of the tax lien." Id. See also Gold Coast Leasing Co. v California Carrots, Inc., 93 CA3d 274, 155 CalRptr 511 (Ct of Appeals 1979) (creditor's security interest in accounts receivable generated from services rendered subsequent to the filing of the notice of tax lien and outside the 45-day safe harbor was not entitled to priority under § 6323).

Because the feeder pigs did not exist before the filing of the notices of federal tax lien or within 45 days thereafter, and because the feeder pigs are not proceeds of the sows, the IRS has priority over PCA with respect to the feeder pigs. Upon their birth in December, 1992 or January, 1993, PCA's interest in the feeder pigs attached. However, the federal tax lien dates from the time of its filing in September, 1989. See United States v McDermott, -- US --, 113 SCt 1536, 1530 (1993) ("under the language of § 6323(a) . . . the filing of notice renders the federal tax lien extant for 'first in time' priority purposes regardless of whether it has yet attached to identifiable property").

Finally, PCA argues that the IRS does not have a lien in the feeder pigs because it filed its notice of lien in Green, rather than Lafayette County where the feeder pigs are located. Section 6323(f)(1)(A)(ii) provides that the notice of federal tax lien must be filed "[i]n the case of personal property, whether tangible or intangible, in one office within the State (or the county, or other governmental subdivision), as designated by the laws of such State, in which the property subject to the lien is situated . . . ." Section 6323(f)(2)(B) provides that, for purposes of the above provision, the situs of personal property is at the residence of the taxpayer at the time the notice of lien is filed. Wis.Stat. § 779.97(2)(c) states that the notice of federal tax lien should be filed "in the office of the register of deeds of the county where the person against whose interest the lien applies resides at the time of filing of the notice of lien." In accordance with these provisions, the IRS properly filed its notices of tax lien in Green County, the county in which the debtors reside, rather than in Lafayette County, the county in which the feeder pigs were located.

For the foregoing reasons, the IRS has priority over PCA with respect to the feeder pigs.

END NOTES:

1. The plan provided for the sale of the livestock on or before March 1, 1993. By order of this court dated February 5, 1993, that time limit was extended until the latter half of March, 1993.

2. See Second Stipulation and Order Between PCA and IRS, filed on December 28, 1992.

3. Section 6323(c)(1) provides in relevant part:

(c) Protection for certain commercial transactions financing agreements, etc.--

(1) In general.--To the extent provided in this subsection, even though notice of a lien imposed by section 6321 has been filed, such lien shall not be valid with respect to a security interest which came into existence after tax lien filing but which--

(A) is in qualified property covered by the terms of a written agreement entered into before tax lien filing and constituting--

(i) a commercial transactions financing agreement,

. . . and

(B) is protected under local law against a judgment lien arising, as of the time of tax lien filing, out of an unsecured obligation.

26 USC § 6323(c).

4. The legislative reports on the 1966 amendments provide little guidance on whether Congress intended to codify the choateness doctrine. See 1A Secured Transactions under the U.C.C., § 7F.06[2][c] at 7F-35 (Matthew Bender 1993). The House Report accompanying the legislation stated:

Under decisions of the Supreme Court a mortgagee, pledgee, or judgment creditor is protected at the time notice of the tax lien is filed if the identity of the lienor, the property subject to the lien, and the amount of the lien are all established at such time. . . . Except as otherwise provided, subsection (a) of new section 6323 retains this basic rule of Federal Law . . .

* * *

The holder of a security interest has priority over a Federal tax lien, if, at the time notice of the tax lien is filed, the security interest exists within the meaning of section 6323(h)(1). . . .

Id. (citing Staff of House Comm on Ways and Means, 89th Cong, 2d Sess, Legislative History of HR 11256, The Federal Tax Lien Act of 1966 at 35 (Comm Print 1966)). Conversely, the Senate Report provided:

The substitution of "holder of a security interest" for "mortgagee" and "pledgee" replaces the latter terms with a more general term used in the Uniform Commercial Code. More important, however, it is intended that, under the bill, the various types of interests defined in this provision [§ 6232(h)] are to have a priority over a nonfiled Federal tax lien if they come within the definitions of these terms . . . whether or not in all other regards they are definite and complete at the time notice of the tax lien is filed.

Id. at 7F-36 (citing S Rep No 1708, 89th Cong, 2d Sess, reprinted in 1966 USCode Cong & Admin News 3723, 3724).

5. See, e.g., Centex Construction Co. v Kennedy, 332 FSupp 1213, 1214 (SD Tex 1971), in which the court stated:

While the term "security interest" as defined in paragraph (h)(1) of said § 6323 differs in a number of respects from the way it is defined in the Uniform Commercial Code, nevertheless, it seems reasonable to say that what is properly the subject matter of a "security interest" under the Uniform Commercial Code would also be property under the Tax Lien Act of 1966, unless the expression in the tax lien act, "property in existence," carries forward the "choate" doctrine to such extent that property, because it is subject to a condition which cannot be violated without liability, is not "choate."

6. Section 6323(c)(2)(A) provides:

The term "commercial transactions financing agreement" means an agreement (entered into by a person in the course of his trade or business)--

(i) to make loans to the taxpayer to be secured by commercial financing security acquired by the taxpayer in the ordinary course of his trade or business, or

(ii) to purchase commercial financing security (other than inventory) acquired by the taxpayer in the ordinary course of his trade or business;

but such an agreement shall be treated as coming within the term only to the extent that such loan or purchase is made before the 46th day after the date of tax lien filing or (if earlier) before the lender or purchaser had actual notice or knowledge of such tax lien filing.

7. There may be a question whether this exception applies in the first instance. The exception applies only to "commercial financing security" which is limited to certain types of paper, accounts receivable, mortgages, and inventory. The livestock in which PCA claims a prior security interest must therefore constitute "inventory." The Treasury regulation for § 6323(c) states:

For purposes of this subparagraph, the term "inventory" includes raw materials and goods in process as well as property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

26 CFR § 301.6323(c)-1(c). As explained by one commentator, "[i]n Article 9 terms, [commercial financing security] does not include goods other than inventory such as equipment or farm products . . . ." Clark, The Law of Secured Transactions Under the Uniform Commercial Code, ¶ 5.07[1] at 5-20 (Warren, Gorham & Lamont, 2d ed. 1988). There may be a question whether the livestock constitutes inventory or farm products.

8. Under Wis.Stat. § 409.306(1) "proceeds" includes "whatever is received upon the sale, exchange, collection or other disposition of collateral or proceeds."

9. Even if this court were to hold that offspring of livestock may constitute proceeds of that livestock, to prevail under the theory that the feeder pigs are identifiable proceeds of the sows, PCA would have to establish that the feeder pigs represent offspring of sows that existed on or before the 45th day after September 13, 1989. Nothing in the record traces the feeder pigs at issue to particular, identified livestock.