

# Government Claim vs. Prior Perfected Mortgage Lien: Who Wins Under the Federal Priority Statute?

The Federal Priority Statute, as it is presently codified at 31 U.S.C. § 3713 or one of its predecessors, has been in effect since 1797.<sup>1</sup> Despite its long history, the statute is not very well known.<sup>2</sup> The Federal Priority Statute grants the government priority over all other claims in certain situations when an insolvent debtor's property is held by an assignee, including in state court receiverships. While this priority appears absolute from the language of the statute,<sup>3</sup> courts have implied limited exceptions. One such exception applies to prior perfected mortgage liens and security interests. In addition to this implied exception, a secured creditor may argue that allowing the government to destroy the value of the creditor's mortgage lien also violates the Takings Clause of the Fifth Amendment.

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## Implied "Specific and Perfected Lien" Exception

The United States Supreme Court has established that the Federal Priority Statute creates a priority only for payment and does not create a lien in favor of the government. *See United States v. Fischer*, 6 U.S. 358, 390 (1805) ("On this subject it is to be remarked, that no Lien is created by this law"). In other words, the United States remains an unsecured creditor with a right to prior payment. As a result, courts imply an exception to the Federal Priority Statute for prior liens that are "specific and perfected." *See Straus v. United States*, 196 F.3d 862, 864 (7th Cir. 1999) ("Although the Federal [Priority] Statute, on its face and taken alone, is absolute ... the Supreme Court has recognized several exceptions to the general priority rule the statute dictates. The first exception is for a specific and perfected lien."). In *United States v. City of New Britain*, 347 U.S. 81, 84 (1954), the Supreme Court discussed that a mortgage, by its nature, is a specific lien. When properly perfected, a mortgage lien should defeat the government's priority under the Federal Priority Statute.

Some confusion can arise when reconciling the specific and perfected lien exception with the Supreme Court's ruling in *Thelusson v. Smith*, 15 U.S. 396 (1817). In that case, Thelusson obtained a judgment that constituted a lien on the debtor's real property. After the debtor made an assignment for the benefit of creditors, the United States obtained judgments against the debtor and levied on his real property. Thelusson brought an action to recover proceeds of the sale to

satisfy his judgment. The Court determined that the United States primed Thelusson's lien because no change in title had occurred and Thelusson did not possess the property before the United States' priority attached. The *Thelusson* "title or possession test" has been echoed in later Federal Priority Statute case law.<sup>4</sup> However, it should be noted that *Thelusson* dealt with a judgment creditor, not a holder of a perfected mortgage lien. Additionally, when *Thelusson* was decided in 1817, there was no procedure for recording a judgment and creating a choate lien on real property. So, unlike a mortgage that is "specific and perfected," Thelusson's judgment would not have been sufficiently perfected or specific to defeat the United States' priority.

## Unconstitutionality Under the Takings Clause of the Fifth Amendment

Construing the Federal Priority Statute to allow a government claim to take priority over a perfected mortgage lien without just compensation may also be unconstitutional under the Takings Clause of the Fifth Amendment. Mortgages and security interests are considered "property" within the meaning of the Fifth Amendment.<sup>5</sup> The total destruction of a mortgage lien's value by the government's assertion of priority under the Federal Priority Statute without payment of just compensation "has every possible element of a Fifth Amendment 'taking' ...." *Armstrong v. United States*, 364 U.S. 40, 48 (1960).

In *Armstrong*, a subcontractor on a Navy ship-building contract obtained a statutory materialman's lien under state law. The contract between the prime contractor and the government provided that, in the event of default, the government had the right to terminate the contract, take title to the boats, and take possession of all completed and uncompleted work and manufacturing materials. The prime contractor defaulted and the government took possession of the boats. The subcontractor argued that the government's action constituted a "taking" because it destroyed the subcontractor's liens. The Supreme Court agreed, stating that "[b]efore the liens were destroyed, the lienholders admittedly had compensable property. Immediately afterwards, they had none. This was not because their property vanished into thin air. It was because the Government for its own advantage destroyed the value of the liens ...." *Id.* This case demonstrates that where a party has taken all necessary steps to create a lien, as a lender with a perfected mortgage has done, the party creates a property right that is protected by the Fifth Amendment and cannot be deprived of that property right without just compensation.

Though the body of case law interpreting the Federal Priority Statute demonstrates that a prior perfected mortgage lien should defeat the government's priority, government agencies may still try to assert absolute priority based upon the plain language of the statute. It is important for lenders with a perfected mortgage or security interest to understand the interplay between the statute, case law, and constitutional considerations so that they are not defeated in priority and deprived of their constitutionally protected property rights.

If you have any questions on the topics discussed in this e-alert, please contact your Reinhart attorney or any member of Reinhart's [Business Reorganization team](#).

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<sup>1</sup> Precursors to the Federal Priority Statute were enacted in 1797 and 1799. Because there has been no material change to the statute since that time, early cases discussing the statute are still authoritative. See Richard H.W. Maloy, *The "Priority Statute" - The United States' "Ace-in-the-Hole,"* 39 J. Marshall L. Rev. 1205, 1271-72 (2006).

<sup>2</sup> See *United States v. Mountzoures*, 376 F. Supp. 2d 13, 16 (D. Mass. 2005) (conceding that neither the defendant nor the Bureau of Prisons knew about the Federal Priority Statute until they were informed of its existence by the Department of Justice).

<sup>3</sup> 31 U.S.C. § 3713 provides:

1. A claim of the United States Government shall be paid first when—
  1. a person indebted to the Government is insolvent and—
    1. the debtor without enough property to pay all debts makes a voluntary assignment of property;
    2. property of the debtor, if absent, is attached; or
    3. an act of bankruptcy is committed; or
  2. the estate of a deceased debtor, in the custody of the executor or administrator, is not enough to pay all debts of the debtor.
2. This subsection does not apply to a case under title 11.

2. A representative of a person or an estate (except a trustee acting under title 11) paying any part of a debt of the person or estate before paying a claim of the Government is liable to the extent of the payment for unpaid claims of the Government.

<sup>4</sup> See *United States v. Estate of Romani*, 523 U.S. 517, 529 (1998) ("The Court has sometimes concluded that a competing creditor who has not 'divested' the debtor of 'either title or possession' has only a 'general, unperfected lien' that is defeated by the Government's priority").

<sup>5</sup> *United States v. Sec. Indus. Bank*, 459 U.S. 70, 76 (1982) ("The 'bundle of rights' which accrues to a secured party is obviously smaller than that which accrues to an owner in fee simple, but the government cites no cases supporting the proposition that differences such as these relegate the secured party's interest to something less than property").

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