2010

Ending Surprise Liens on Real Property

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ABSTRACT

Academics, lawmakers, and the general public have long believed that "secret liens" are problematic. In real property, these are liens that are not recorded in the real property filing system. Secret liens become especially problematic when they are enforced, despite their secrecy, against subsequent purchasers of the property. If the purchaser does not satisfy the lien by paying the underlying debt, the lien holder can foreclose on the property. One of the main purposes of having real property recording statutes was to avoid "surprise liens" (secret liens afforded priority over subsequent purchasers) and ensure that real estate purchasers and investors are fully informed. Yet, surprise liens continue to exist and are, in fact, increasingly accepted by lawmakers.

This Article examines two prototypical surprise liens—federal estate tax liens and mechanics' liens—and proposes that these are indicative of a trend wherein modern lawmakers are increasingly tolerant of surprise liens. This Article then examines potential justifications for this deviation from the longstanding preference against these types of liens. First, some argue that property filing systems are economically inefficient. Second, some argue that creditors and purchasers do not actually check property filing systems. Finally, the article identifies and addresses the possibility that law makers justify surprise liens based upon the identity of the lienor.

After examining these arguments, this Article concludes that the first two justifications are convincingly countered by existing economic theory and circumstances and that creditors and buyers do, in fact, rely on real property records. This leaves lienor identity as the true driver behind the rising acceptance of surprise liens. This justification, identified herein, is ultimately based upon the perceived socio-economic benefits arising from granting these favored classes the right to surprise liens. A careful examination of the full economic consequences of surprise liens, however, demonstrates that this justification is not sufficient, and is ultimately self-defeating.

Granting special rights to certain classes of lienors imposes higher individual costs than is commonly believed and also creates significant costs that likely counter any socio-economic benefits actually created. Additionally, surprise liens (even if economically justified) defeat basic conceptions of fairness inherent in the American system of jurisprudence and arising out of basic concepts of due process and social ethics. This Article therefore concludes that these liens should be removed through a strengthening of recording concepts at both a state and federal level.

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TABLE OF CONTENTS

I. INTRODUCTION

Imagine you want to buy a house. You find the perfect place, exactly where you want to live, exactly the style you want. Like almost everybody, you do not have enough money to buy the house outright, so you need a mortgage. Getting a mortgage makes you nervous—you are taking on a principal obligation that is more money than you will make in the next five to ten years combined. But, everyone assures you, this is a safe financial decision—so long as you do not buy for speculation at the peak of a bubble, your newly purchased asset will adequately secure your obligation and ensure that you are not left responsible for an enormous debt if you suddenly lose your job or get sick. You are still nervous, though, about such a complicated and significant transaction, so you take the relatively extraordinary step of talking to a real estate lawyer. He says the same thing as your friends: your loan will be secured by your new house, and no bank will make a home loan to you unless you buy title insurance, which literally ensures that you will have clear title and that the bank will have a first-place protected interest in your new home.

That does it. Feeling confident, you take out the loan and buy the house. You move in and start to settle down. Then you get a letter from the Internal Revenue Service (IRS). Your house is subject to an estate tax lien and will be seized unless you pay the full amount of estate tax that is currently owed by the estate of the fellow who sold the house to the woman from whom you bought it. Frantically, you call your lawyer. This cannot be right, can it? The IRS cannot have a superior lien based on the taxes owed by the estate of somebody you never met and who owned the home more than five years ago, can it? The lawyer reviews the IRS notice and does some research. Red-faced, he tells you the IRS can, indeed, seize your new home, even though you bought title insurance and the title insurer examined the public records. He had never heard of the estate tax lien until now, but it gives the IRS an interest that does not have to be filed anywhere and that still takes precedence over your rights.[1] You have been victimized by a "surprise lien."[2]

Most people, and most attorneys, believe that bona fide purchasers of real property are protected against unknown third parties later claiming superior title or rights.[3] This belief is based upon a mostly accurate understanding of real property recording acts and title insurance.[4] Every state in the country has adopted its own real property recording act,[5] which creates an incentive for creditors and claimants to record publicly any claims they might have to real property.[6] Title insurers use these public records to review such claims and

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[1] *See infra* Part III.A.1.

[2] The individual consequences of this may be muted due to title insurance, though this is not necessarily the case. *See infra* Part IV and note 73 and accompanying text. Moreover, even if title insurance protects the individual at issue, it does not justify the existence of surprise liens on a social scale. *See infra* Part V.B.

[3] *See, e.g.*, MidCountry Bank v. Krueger, 762 N.W.2d 278, 282 (Minn. Ct. App. 2009).

[4] *See, e.g.*, *id.* Title insurance insures against the loss that an insured party suffers due to the condition of title being less than it was insured to be. *See* John C. Murray, *Title and Survey Issues in Commercial Real Estate Transactions*, *in* UNDERSTANDING THE SOPHISTICATED REAL ESTATE PRACTICE 55, 57-58 (Practising Law Institute ed., 2003).

[5] *See, e.g.*, ALA. CODE § 35-4-90 (1991); ALASKA STAT. ANN. § 34.15.010 (2010); ARIZ. REV. STAT. ANN. § 33-411.01 (2007); ARK. CODE ANN. §§ 18-40-102, 14-15-404 (West 2004 & Supp. 2010); CAL. CIV. CODE § 1214 (West 2007); COLO. REV. STAT. ANN. § 38-35-109 (West Supp. 2010); CONN. GEN. STAT. ANN. § 47-10 (2009); DEL. CODE ANN. tit. 25, § 153 (West 2006); D.C. CODE § 42-406 (2010); FLA. STAT. ANN. § 695.01 (West 1994); GA. CODE ANN. § 44-2-1 (West 2003); HAW. REV. STAT. § 502-83 (West 2008); IDAHO CODE ANN. § 55-812 (West 2006); 765 ILL. COMP. STAT. ANN. 5/30 (West 1993); IND. CODE ANN. § 32-21-3-3 (West 2002); IOWA CODE § 558.41 (Supp. 2010); KAN. STAT. ANN. §§ 58-2222 to -2223 (1994); KY. REV. STAT. ANN. § 382.270 (West Supp. 2010); LA. REV. STAT. ANN. § 9:2721 (Supp. 2011); ME. REV. STAT. ANN., tit. 33, § 201 (1999); MD. CODE ANN., REAL PROP. § 3-101 (West Supp. 2010); MASS. GEN. LAWS ANN. ch. 183, § 4 (West 2003); MICH. COMP. LAWS. ANN. § 565.29 (West 2006); MINN. STAT. ANN. § 507.34 (West 2002); MISS. CODE ANN. § 89-5-5 (West 1999); MO. ANN. STAT. § 442.390 (West 2000); MONT. CODE ANN. § 70-21-304 (2009); NEB. REV. STAT. § 76-238 (LexisNexis Supp. 2010); NEV. REV. STAT. §§ 111.320, .325 (2009); N.H. REV. STAT. ANN. § 477:3-a (2001); N.J. STAT. ANN. § 46:22-1 (West 2003); N.M. STAT. ANN. § 14-9-3 (West 2003); N.Y. REAL PROP. LAW § 291 (McKinney 2006); N.C. GEN. STAT. ANN. § 47-18 (West Supp. 2010); N.D. CENT. CODE ANN. § 47-19-41 (West 2008); OHIO REV. CODE ANN. §§ 5301.23, .251 (West 1995); OKLA. STAT. ANN. tit. 16, § 16 (West 1999); OR. REV. STAT. ANN. § 93.640 (West 2010); 21 PA. CONS. STAT. ANN. §§ 351, 622 (West 2001); R.I. GEN. LAWS ANN. § 34-1-1 (West 2006); S.C. CODE ANN. § 30-7-10 (2007); S.D. CODIFIED LAWS § 43-28-17 (2004); TENN. CODE ANN. § 66-5-106 (West 2002); TEX. PROP. CODE ANN. § 13.001 (West 2004); UTAH CODE ANN. § 57-3-102 (West 2004); VT. STAT. ANN. tit. 27, § 342 (West 2007); VA. CODE ANN. § 55-96 (West 2010); WASH. REV. CODE ANN. § 65.08.070 (West 2005); W.VA. CODE ANN. §§ 39-1-2b, 40-1-8 (West 2002); WIS. STAT. ANN. § 706.08 (West 2001 & Supp. 2010); WYO. STAT. ANN. § 34-1-120 (West 2007).

[6] *See, e.g.*, Dale A. Whitman, *Teaching Property—A Conceptual Approach*, 72 MO. L. REV. 1353, 1359 (2007).

guarantee title to a potential buyer or lender.[7] At least, that is how the system is supposed to function.

Increasingly, however, judicial and legislative authorities are creating exceptions to this system and permitting lienors to assert secret claims that are afforded priority over subsequent bona fide purchasers for value.[8] The term "secret lien" refers to the situation that arises "whenever one party asserts an interest in property that is neither recorded nor otherwise readily observable."[9] Secret liens present numerous problems, including, but not limited to, preventing potential creditors from properly and accurately assessing the nature of a potential debtor and causing subsequent creditors or buyers to ignorantly rely upon incomplete information or purchase a property interest that is less than it appears.[10] While all of these problems give rise to the poor reputation of secret liens,[11] this Article focuses primarily on the latter—that is, the potential for a secret lien to be afforded priority status under the law and surprise a subsequent titleholder. Accordingly, this Article refers to such liens—those that are both secret and ultimately afforded superior rights to those held by bona fide purchasers[12]—as "surprise liens."[13]

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[7] Dale A. Whitman, *Are We There Yet? The Case for a Uniform Electronic Recording Act*, 24 W. NEW ENG. L. REV. 245, 245 n.2 (2002) (explaining that title insurance companies use public records "as a point of 'daily takeoff' of the recorded documents, which are then placed in privately-owned 'title plants' where the actual searches are performed").

[8] *See infra* Part III.

[9] Jonathan C. Lipson, *Secrets and Liens: The End of Notice in Commercial Finance Law*, 21 EMORY BANKR. DEV. J. 421, 424 (2005).

[10] *See* Michael Simkovic, *Secret Liens and the Financial Crisis of 2008*, 83 AM. BANKR. L.J. 253, 255-56 (2009).

[11] *See, e.g.*, K. N. Llewellyn, *Across Sales on Horseback*, 52 HARV. L. REV. 725, 730 (1939).

[12] As used herein, the term "bona fide purchaser for value" is not based on a statutory definition and is instead given a broad meaning, derivative of the common law concept of one who gains an interest in property for fair value and in good faith believing the seller possessed full rights to the transferred property interest. *See, e.g.*, 3 LYNDEL V. PROTT & P.J. O'KEEFE, LAW AND THE CULTURAL HERITAGE: MOVEMENT 396-416 (1989) (defining bona fide purchaser as one who purchased property from seller, honestly believing seller had right to sell property, and absent any dubious circumstances that would put buyer on notice to contrary); Seth D. Harris, *Innocence and* The Sopranos, 49 N.Y.L. SCH. L. REV. 577, 635 (2004) ("A 'bona fide purchaser for value' makes a good-faith purchase of real property by exchanging fair value for the property without actual or constructive notice of any infirmities, claims, or equities against the title."). A creditor taking a security interest in a piece of property may qualify as a "bona fide purchaser for value," as it is giving value in exchange for its security interest. David Hayton, *The Uses of Trusts in the Commercial Context*, *in* MODERN INTERNATIONAL DEVELOPMENTS IN TRUST LAW 145, 154 (David Hayton ed., 1999).

[13] The term "secret lien" is sometimes defined consistently with this. 53 C.J.S. *Liens* § 45 (2010). However, that is not always the case as "secret lien" may also refer to a lien that is merely unknown but that does not enjoy priority as of attachment. *See* Simkovic, *supra* note 10, at 256-58. This Article therefore coins the term "surprise lien" to describe a lien that is both secret and ultimately afforded rights superior to those of bona fide purchasers. Of note, a surprise lien is different than a "priming lien." Whereas a surprise lien attaches to property before the interest over which it is eventually given a perfected priority, a priming lien both attaches and is perfected after the interest that is "primed." This is a subtle distinction, but it is instructive as to the true nature of surprise liens and the implications it raises regarding their growing relevance. *See infra* Part IV.C.

Although historically addressed by recording acts and other notice systems, surprise liens on real property are making an unanticipated, and largely unexamined, comeback.[14] This Article diagnoses this situation and examines two types of liens symbolizing this emerging trend wherein legislative and judicial authorities are increasingly tolerant of surprise liens and the consequences that follow. There are various potential reasons for this increased tolerance, but the true justification lies in an *ad hoc* approach by lawmakers that view permitting extraordinary and superior rights to certain classes of lienors as maximizing socio-economic benefit.[15] This Article argues that the socio-economic-benefit justifications are insufficient and ultimately self-defeating and concludes that the most efficient and fair approach is a systemic one that universally disallows surprise liens as exceptions to real property recording acts.

Part II examines the history of surprise liens and the legal methods created to address them. The recording acts upon which we now rely were developed as a basic attempt to publicize real property interests so that buyers and creditors could make fully informed decisions. Initially, the law performed this function by focusing on possessory rights, but it has since adapted by creating a coherent notice system, the creation and maintenance of which is required by the states' recording acts.[16] This system is intended to be a "well-integrated method of establishing the rights to the title of a parcel of real property"[17] and to avoid the danger of subsequent purchasers being surprised by superior liens. As Part III points out, however, there are important surprise liens—such as the estate tax lien and mechanics' liens—that are exceptions to this "well-integrated" system, which inject underappreciated, but significant, amounts of cost and uncertainty into modern real estate transactions. These types of surprise liens have not been adequately addressed in academic literature, and Part IV attempts to remedy this dearth of research by examining three potential justifications for such liens. Part V argues that two of the justifications for secret liens are refutable by contrary academic theory and current events, and that, as such, the true reason behind lawmakers' increasing willingness to countenance these liens is a positive and normative decision that permitting certain classes of lienors to accede to an extraordinary lien will create socio-economic benefits sufficient to outweigh the damage done to the individual rights of the affected bona fide purchaser. This justification is not convincing, however, and this Article concludes that surprise liens should be effectively removed through a strengthening of recording concepts at both a state and federal level.

II. THE HISTORY OF SURPRISE LIENS ON REAL PROPERTY

The law has long been concerned with how to ensure that interested parties have, or can reasonably attain, information regarding possessory and ownership rights. Indeed, this seemingly innocuous issue is at the very heart of what property law "does"—proscribes and defines the rights of ownership in

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[14] *See infra* Part III.B.

[15] *See infra* Part IV.

[16] *See* Lipson, *supra* note 9, at 435-55.

[17] Ray E. Sweat, *Race, Race-Notice and Notice Statutes: The American Recording System*, PROB. & PROP., May-June 1989, at 27, 27.

property.[18] Surprise liens are invidious to this goal because they act outside accepted norms and systems and convey unknown interests to unknown parties.

The law's attempt to address this problem has evolved over time. Under English common law, ritualized ceremonies, physical possession, and specialized documents symbolized and embodied transfers and so created extant acts or items to which third parties could hypothetically refer in attempting to fully understand ownership.[19] These systems, however, placed much onus on third parties, did not adequately convey information, and thus obstructed modernized commerce.[20] The American response in the real property context was the recording act, a highly effective attempt to publicize and make uniform the type and source of information necessary to ensure adequate information.[21]

A. *The Common Law Approach to Surprise Liens*

Under common law, title to real property was transferred by "enfeoffment," a complete surrender and transfer of all land ownership rights from the transferor to the transferee.[22] This was accomplished through the livery of seisin, a ceremony involving the physical transfer by the transferor to the transferee, in the presence of witnesses, of a piece of the ground (often, in the literal sense of a hand-to-hand passing of an amount of soil), a twig, key, or other symbol.[23] Once this occurred, the transferor had no further interest and could no longer transfer or encumber title, even though there was no writing to memorialize the transfer.[24] This method for transfer and acknowledgment of rights is the genesis of "first in time, first in right," a concept still prevalent, though now formalized and publicized.[25]

Written documents later came into use as a necessary method of memorializing conveyances, with formalization coming in 1535 via the Statute of Uses.[26] This law, devised by Henry VIII as a revenue-raising measure, aimed to simplify the nature of land ownership and effectively did away with the requirement of enfeoffment.[27] This statute was joined a year later by the Statute of Enrolments, which aimed to simplify property transfers even more and effectively required most transfers of property to be registered with a public official, thereby significantly reducing the likelihood and prevalence of surprise

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[18] *See* Carol M. Rose, *Crystals and Mud in Property Law*, 40 STAN. L. REV. 577, 577 (1988) (indicating that property law works when its "rules . . . signal to all of us, in a clear and distinct language, precisely what our obligations are and how we may take care of our interests").

[19] *See* Sweat, *supra* note 17, at 27.

[20] *See* Arthur R. Gaudio, *Electronic Real Estate Records: A Model for Action*, 24 W. NEW ENG. L. REV. 271, 272-74 (2002).

[21] *See id.*; Sweat, *supra* note, 17, at 27-28.

[22] Sweat, *supra* note 17, at 27.

[23] *Id.*

[24] *Id.*

[25] *See infra* Part II.B.

[26] Sweat, *supra* note 17, at 27.

[27] *Id. See also* George Lee Flint, Jr. & Marie Juliet Alfaro, *Secured Transactions History: The First Chattel Mortgage Acts in the Anglo-American World*, 30 WM. MITCHELL L. REV. 1403, 1433-44 (2004).

liens.[28] The Statute of Enrolments, however, proved unpopular and largely ineffective because it was easily avoided by simply transferring a leasehold estate (instead of an estate of inheritance or freehold) and then immediately releasing the transferor's reversionary interest to the lessee-transferee.[29]

These haphazard and easily avoided writing requirements were largely obviated in 1677 by the Statute of Frauds. After its enactment, written documents were necessary to create or transfer most real property interests in most situations.[30] Public ceremonies and public knowledge were no longer required, and the law took a significant step toward uniformity in the method of transfer.

However, this uniformity, while necessary to ultimately defeating the scourge of surprise liens, was not sufficient. Even after the Statute of Frauds was passed, there was no system to make others aware of the written passage of title because all deeds to real property were conveyed with the land to the transferee.[31] There was no uniform system to evidence transfer or to otherwise signal ownership—if a transferor wished to alienate title, ownership was demonstrated by producing the written deed or some other instrument of title.[32] As such, transferees had no independent way to verify priority and secret liens were still problematic.[33]

B. *The Statutory Approach to Surprise Lien*

Recording acts addressed this problem of transferees not being able to consistently confirm their priority positions. The concept of recording written documents, tentatively begun in England, started to gain widespread acceptance and usage by colonial times.[34] America was founded at a time when the importance of land was shifting from its historical role as a font of wealth and status to its modern role as a commodity to be bought and sold according to the exigencies of commerce.[35] This was particularly true in the new world, which was not bound by the contemporary mores and aristocratic values still prevalent

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[28] Though it is often claimed that this laudatory effect was the primary intent of the law, modern academics instead assert that the true purpose of the law was to permit the king to keep an accurate record of who his freeholders were and from where his revenues should have been originating. *See* Flint & Alfaro, *supra* note 27, at 1433-34.

[29] Sweat, *supra* note 17, at 27.

[30] *See* Alberto Luis Zuppi, *The Parol Evidence Rule: A Comparative Study of the Common Law, the Civil Law Tradition, and* Lex Mercatoria, 35 GA. J. INT'L & COMP. L. 233, 236-37 (2007).

[31] Sweat, *supra* note 17, at 27.

[32] *Id.*

[33] *See, e.g.*, GILBERT'S COLLIER ON BANKRUPTCY ¶ 1343 (Samuel M. Hesson ed., 3d ed. 1934) ("The object of recording acts is to prevent the obtaining of credit by reason of the ostensible ownership of property which in reality is covered by a secret lien by giving notice to those intending to purchase such property and to creditors who give credit on the faith thereof.").

[34] Even prior to the Norman Conquest, there was a system of voluntary registration of land deeds overseen by local monasteries. John Hanna, *The Extension of Public Recordation*, 31 COLUM. L. REV. 617, 620 (1931). Recording, though, was not strictly mandatory, and there was no uniformity. *See id.* at 619-20.

[35] Gaudio, *supra* note 20, at 272. This shift was only heightened by the widespread advent of mortgage liens, a direct outgrowth of the new view of land as a resource to be utilized commercially. *Id.* at 272.

in the old world.[36] Accordingly, the ancient problem of surprise liens presented more of a problem than ever.

Individuals and entities increasingly required an efficient and reliable method to review prior conveyances. The fitful writing and notice requirements then available did not suffice, and few owners possessed a complete record of prior conveyances.[37] Even those who did could not be trusted to produce all records of every lien ever touching upon the property.[38]

It is in this context that colonial legislatures began to establish the first "American" land recording systems.[39] In 1640, the General Court of the Massachusetts Bay Colony adopted the first modern recording act. The act stated that an unrecorded instrument was good as between the parties even though not recorded, but required it to be recorded within a specific amount of time to be good against unknowing third parties.[40] A full recitation of all relevant facts was not required, and only the essential elements of the conveyance (such as the name of the grantor and grantee, a description of the property and estate granted, and the date of transfer) had to be recorded.[41]

Though simple in nature, this represented an important change from the haphazard English system.[42] Public, written notice was no longer a matter of local custom or a technicality easily avoided if desirable. Under this new system, in order to convey a defensible interest in real property, one had to put others on notice of the conveyance. Moreover, this new system provided the basis for the more sophisticated recording statutes of today.[43]

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[36] The first known recordation in America occurred in 1627 at Plymouth Colony. Sweat, *supra* note 17, at 27.

[37] Gaudio, *supra* note 20, at 272.

[38] *Id.*

[39] *See id.* This intensified throughout the Industrial Revolution, which created an "unprecedented demand for credit" that eventually spread from real to personal property. *See* 1 GRANT GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY § 2.1 (5th prtg. 2007).

[40] *See* 1 RECORDS OF THE GOVERNOR AND COMPANY OF THE MASSACHUSETTS BAY IN NEW ENGLAND, 1628-1641, at 306 (Nathaniel B. Shurtleff ed., 1853). An explicit goal of such laws was to address the problem of fraudulent conveyances. *See* Mark DeWolfe Howe, *The Recording of Deeds in the Colony of Massachusetts Bay*, 28 B.U. L. REV. 1, 3 (1948). In fact, there is some reason to believe that preventing fraudulent conveyances might have been the *primary* goal of these initial acts. Certain amendments to the Massachusetts statute indicate that recording was required only where a grantor retained possession of the property following the transfer of an interest. *See id.* at 3-4. Such a focus evinces a preoccupation with surprise liens, albeit in a historical context, wherein nonpossessory lienhold interests were not prevalent.

[41] Sweat, *supra* note 17, at 27-28.

[42] These recording acts, while advancing the interests identified herein by publicly promulgating the type of information needed by third parties, were also likely viewed as revenue generating systems, as they effectively operated as a tax on conveyances. *See, e.g.*, *infra* note 110.

[43] Initially, a simple paper system whereby the recorder manually copied the transfer document into the records of the town or county was reasonably workable and sufficient to impart the requisite notice. Of course, as time has gone by, document records have multiplied, initially due to the passage of time and concomitant accumulation of transfers but increasingly due to the complicated and sophisticated nature of real property commerce and finance. *See* Gaudio, *supra* note 20, at 272-74. This complexity was initially addressed by the introduction of indices tied first to names and later to parcel numbers. *See id.* Recently, this complexity has been addressed with more efficient copying systems, computer databases,

Like much of real property law, the rules regarding recording are local. Most governing law is based on state statutes and state-court interpretations of these statutes.[44] There are, however, broad rules applicable across all jurisdictions.[45] In particular, there are three generic types of recording acts, known as "notice," "race-notice," and "race."[46] Under the notice acts, unrecorded conveyances are invalid against subsequent transferees without notice, regardless of who records first.[47] Under the race-notice acts, the subsequent transferees have priority only if they are without notice of the first transferee and they record first.[48] Finally, under the pure race-type acts, the subsequent transferees have priority if they record before the initial transferee, even if aware of the earlier conveyance.[49] This type of statute creates a "race to the courthouse."

Initially, recording acts were primarily of the race type, but most modern recording acts are of the notice type.[50] The effect of these statutes is to protect bona fide purchasers for value, except in race states, which provide protection even if the subsequent transferee has knowledge. The clear practical effect is to protect subsequent transferees from all manner of secret transfers.[51] This system, then, functions to alleviate the age-old problem of surprise liens, so long

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and Internet capabilities. Still, the basic goal and function of these systems remain the same: to publicize information regarding title to real property.

[44] Sweat, *supra* note 17, at 28.

[45] *Id.*

[46] *Id.*

[47] These statutes generally read as follows: "No conveyance, transfer or mortgage of real property shall be good and effectual in law or equity against creditors or subsequent purchasers for a valuable consideration and without notice, unless the same be recorded." *Id.*

[48] These statutes generally read as follows: "Every conveyance of real estate [that] shall not be recorded shall be void as against any subsequent purchaser in good faith, and for a valuable consideration of the same real estate or any portion thereof, whose conveyance shall be first duly recorded." *Id.*

[49] These statutes generally read as follows: "No conveyance of land . . . shall be valid to pass any property interest as against a purchaser for valuable consideration . . . but from the time of recording." *Id.*

[50] *Id.* Most recording acts, of either type, exclude short-term leases, but cover a significant portion of other interests in land. *Id.* The different types of statutes may have a different effect on the subsequent transferees. For example, assume that Allison transfers Blackacre to Audrey for valuable consideration on January 1 and then again transfers Blackacre to Sophie for valuable consideration on February 1. Neither Audrey nor Sophie records their interest upon transfer, and Sophie has no notice of Audrey's interest. Under a race type statute, if Audrey records first, she will have priority, even if she knows of the subsequent transfer to Sophie; likewise, if Sophie records first, she will have priority. Under a notice statute, Sophie will have priority, regardless of who records first, because, at the time of the transfer to her, Sophie had no notice and Audrey had not recorded. Finally, under a race-notice statute, Sophie will have priority only if she records first.

[51] The effectiveness of recording statutes is further bolstered by bankruptcy protections afforded to creditors who properly record. Under the Bankruptcy Code, a trustee for a bankrupt debtor has the power to exploit defective filing by avoiding flawed transactions. *See* 11 U.S.C. § 544(a)(1) (2006). If avoided, the relevant property becomes available for distribution to all unsecured creditors. This is known as the "strong-arm power" and is borne from a concern about surprise liens. By affording a trustee the same rights as a hypothetical creditor in a hypothetical proceeding, Congress effectively ensured that the bankrupt estate will have the same rights as any other creditor. *See* REPORT OF THE COMMISSION ON THE BANKRUPTCY LAW OF THE UNITED STATES, H.R. DOC. No. 93-137, at 18 (1973). This strong-arm power has only heightened the importance of the recording acts to interest holders whose rights are

as it is consistently and broadly applied.[52] Unfortunately, that is not always the case.

III. Modern Exceptions: The Rising Risk of Surprise Liens

Arising from the evolution described above, American recording acts have largely addressed the historical concern of third parties regarding surprise liens. Unfortunately, this apparent success has not been static. Examining two surprise liens—the estate tax lien and mechanics' liens[53]—one finds modern creations representing a troubling trend whereby lawmakers seem increasingly willing to chip away at the protections traditionally afforded by the recording acts and relied upon by lawyers and lay people alike.

A. *Two Examples of Surprise Liens*

1. *The Estate Tax Lien*

The Internal Revenue Code (IRC) provides that, "[u]nless the estate tax imposed by [the IRC] is sooner paid in full . . . it shall be a lien upon the gross estate of the decedent for 10 years from the date of death."[54] This lien attaches without assessment and has been judged to be immune to the IRC provisions relating to notice filing.[55] As

potentially voidable. *See, e.g.*, James J. White, *Revising Article 9 to Reduce Wasteful Litigation*, 26 Loy. L.A. L. Rev. 823, 830-41 (1993).

[52] Recording acts do not, of course, alleviate all problems associated with conveyances of real property, and may, in fact, create some problems. *See* Sweat, *supra* note 17, at 29-30. For example, though creating a uniform requirement for notice of some type, the recording acts do not necessarily specify what notice will be effective and what documents will provide that notice. Similarly, the local county recording offices, while providing an excellent vehicle for notice systems, do not act as a perfect gate-keeper. As such, there is potential for various transferees, or ostensible transferees, to record varying types of documents and to create confusion and ambiguity for potential subsequent transferees. *See id.* These issues, however, are outside the scope of this Article, which merely examines the ability of recording systems, if properly utilized, to address adequately the problem of surprise liens.

[53] This is not an exhaustive list, but is instead a considered examination of two such liens, how they have arisen, what effect they have on those unfortunate enough to run afoul of them, and why they stand in defiance of modern recording acts and the generally expected effect of the same.

[54] I.R.C. § 6324(a)(1) (2006).

[55] Though contrary to generally accepted wisdom, the law is clear: Unless a federal statute requires a government tax lien to be recorded, the unrecorded lien may be enforced against subsequent transfereees. *See* United States v. Curry, 201 F. 371, 374 (D. Md. 1912); Detroit Bank v. United States, 317 U.S. 329, 337 (1943). The crucial question, therefore, is whether there is any statutory requirement that special estate tax liens be filed. *See* Rev. Rul. 69-23, 1969-1 C.B. 302. Arguably, there is not. *See infra* Part IV.C. The IRS has embraced the lack of a filing requirement and extended its consequences even further by deciding that, under no circumstances, can any § 6324(a) lien ever be filed. *See* Internal Revenue Serv., Internal Revenue Manual § 5.5.7.2 (2005), available at http://www.irs.gov/irm/part5/irm_05-005-007.html#d0e80 ("Notice of the lien cannot be recorded nor is any recording necessary in order for it to become choate."). The IRS believes it is under no legal or ethical obligation to record § 6324 liens and thereby notify bona fide purchasers for value. There are, however, several narrow exceptions to this lien. Section 6324(a)(2) creates a category of transferee liability with respect to recipients of property that is included in a decedent's gross estate under §§ 2034-42 (commonly known as "non-probate property" and

such, the unrecorded lien may be enforced against subsequent bona fide purchasers.[56]

United States v. Vohland illustrates the arbitrary and unfair nature of these "Special Liens for Estate and Gift Taxes" under IRC § 6324.[57] David Schindler Sr. died in April 1970.[58] Approximately two years later, the IRS assessed an estate tax and a supplemental penalty.[59] The executor paid the tax but not the penalty.[60] Subsequently, in late 1973, the Vohlands purchased real property from the Schindler estate without any notice of the estate tax, the accompanying penalty, or an estate tax lien.[61] Approximately five years later, without ever filing a lien, the IRS filed suit to foreclose under § 6324(a)(1).[62] The district court granted summary judgment to the IRS, and the Ninth Circuit affirmed.[63]

Of note, the circuit court explicitly held that the lien "attaches at the time of decedent's death without necessity for assessment or demand,"[64] the § 6324 lien is effective without filing because there is no statutory filing requirement, and "[u]nless a federal statute requires a government tax lien to be recorded, the unrecorded lien may be enforced against subsequent transferees."[65] The Vohlands were out of luck—the lien might have been a surprise, but it was no less effective for that.[66]

including property received via a trust, insurance policy, or joint tenancy with rights of survivorship) and divests the lien on such property upon its transfer to a purchaser or holder of a security interest. Additionally, § 6324(a)(1) removes the lien from property that is sold and the proceeds of which are expended on charges of the estate, and § 6324(c)(1) provides that the lien is not valid against a mechanics' lien and certain other liens and interests described in § 6323(b). Unfortunately for innocent purchasers, this "exception" is exceedingly difficult to satisfy. *See* First Am. Title Ins. Co. v. United States, No. 04-429, slip op. at 2-3 (W.D. Wash. May 12, 2005). Additionally, § 6324(a)(3) provides that property that has been transferred to a purchaser or holder of a security interest after the estate fiduciary has received a discharge under § 2204 is no longer subject to the lien (though the consideration received by the antecedent recipient of the property is).

[56] *See generally Detroit Bank*, 317 U.S. at 329.

[57] *See generally* United States v. Vohland, 675 F.2d 1071 (9th Cir. 1982).

[58] *Id.* at 1073.

[59] *Id.*

[60] *Id.*

[61] *Id.*

[62] *Id.* at 1076.

[63] *Id.* at 1072.

[64] *Id.* at 1074.

[65] *Id.*

[66] Evidently, not content to consign the Vohlands to the consequences of the government's unrecorded lien, the court dryly noted that the statutory exceptions applicable after a fiduciary receives a § 2204 discharge and to transfers of non-probate property "provides purchasers considerable . . . protection" and that the Fifth Amendment's due process requirement was of no use. According to the court, a prospective purchaser has adequate means of avoiding such a result by establishing that the administrator has been released under § 2204. *Id.* at 1076. This proposed solution, of course, presupposes the absence of the very thing complained of—the surprise lien. By ignoring the likelihood that purchasers do not know that the IRS operates outside the generally accepted bounds of property law, the court effectively maintained that the lien is not secret because purchasers should be fully aware that it is not secret. Similarly, the court insisted that the government did not act to surprise the purchasers-cum-lienees because the government did not undertake to foreclose on the lien until *after* the purchasers had acquired it. As such, there was no surprise, there was just a failure of

So, estate tax liens are surprise liens. But why is this lien permitted to exist outside the bounds of the commonly accepted notions of priority and property law? Section IV examines this question in detail, but the prima facie explanation is in a quirk of federal law. Under IRC § 6321, "[i]f any person liable to pay any tax neglects or refuses to pay the same after demand, the amount . . . shall be a lien in favor of the United States upon all property and rights to property, whether real or personal, belonging to such person."[67] This lien arises upon assessment and continues against all of the debtor's property until the tax obligation is satisfied or the relevant statute of limitation expires.[68] Fortunately, the IRC does not stop there. Section 6323 places some constraints on the IRS's all-encompassing lien rights by providing that, with respect to real property, "[t]he lien imposed by section 6321 shall not be valid as against any purchaser . . . until notice thereof" is recorded in an office within the appropriate state, county, or other office, as designated by the laws of the state in which such property is situated.[69] However, the federal courts have decided that this clear mandate simply does not apply to the § 6324 lien. "[T]he differences between [the statutory predecessor to §§ 6321-6323, the general tax lien] and [the statutory predecessor to § 6324, the special estate tax lien], and their legislative history as separate enactments, indicate that each was intended to operate independently of the other."[70]

As such, the § 6324 lien is affirmatively placed outside the reach of all state recording acts, an outlier of federal tax law, surviving all sales and transfers to bona fide purchasers regardless of the apparent equities involved.[71] In

title. Again, this Orwellian response merely responds to the complaint that § 6324 liens are unfair and violate due process requirements by insisting that everyone knows about them and so suffers not at all.

67 I.R.C. § 6321 (2006).

68 *See* Leighton v. United States, 289 U.S. 506 (1933); Glass City Bank of Jeanette, Pa. v. United States, 326 U.S. 265 (1945); *see also* I.R.C. § 6322.

69 I.R.C. § 6323(a).

70 Detroit Bank v. United States, 317 U.S. 329, 334 (1943). The Ninth Circuit recently approved of this proprietary view of federal statutory law, based upon the U.S. Supreme Court's interpretation of legislative history, expressly indicating that none of the intervening changes to federal tax law had altered the reasoning or applicability of the *Detroit Bank* case. *Vohland*, 675 F.2d at 1075. This blatant approval of secrecy is different from other potential conflicts arising in connection with the federal priority granted to tax liens. *See generally* Note, *Federal Priorities and Tax Liens*, 63 COLUM. L. REV. 1259, 1261-63 (1963). As is discussed in greater detail therein, government debts and liens are granted special rights and privileges vis-a-vis other debtors and lienors. Federal common law has evolved a series of tests based upon statutory rights afforded to the government and the government's need to generate revenue for the "public good." *See id.* These issues are interesting in that they potentially permit government liens to supersede, or prime, senior liens. However, they are not surprise liens in the sense that they attach without filing and defeat properly recorded interests of, and transfers to, subsequent bona fide purchasers. Accordingly, they are outside the scope of this Article.

71 The case of *Sessler v. United States* shows the lack of remedy or resort available to a potential lienee when confronted by the IRS. There, Robert and Natalie Sessler purchased land from Robert Granicy and his brother. Unfortunately for the Sesslers, and entirely unbeknownst to them, Robert had inherited the land from his father and had failed to pay the estate tax due upon his father's death. None of the statutory exceptions identified above applied, so the tax lien provided for in § 6323(a)(1) attached at death to all of the property owned by Robert's father and survived the bona fide purchase by the unknowing Sesslers.

other words, any time anyone purchases property anywhere in America, they should perform a chain of title search to determine whether or not an estate is in the chain of title at any time in the last ten years.[72] Anyone failing to do so risks being surprised by an estate tax lien.[73]

2. *Mechanics' Liens*

The next surprise lien—the mechanics' lien—is much more common.[74] Common law provided possessory liens to mechanics and laborers who per-

The IRS came calling in the year following the Sesslers' purchase, giving them six days notice before the property was to be seized. The Sesslers paid the outstanding tax amount to prevent the impending seizure and sale and then brought an action against the IRS for wrongful levy, arguing, essentially, that the law surely cannot condone and encourage surprise liens of this nature. The district court agreed, but the Ninth Circuit overruled its decision, taking a more concrete view of the relevant statutory language. It held that individuals such as the Sesslers can only challenge "wrongful" liens by claiming and demonstrating that they are "wrongful" under federal regulations. This self-serving circularity is distinctly unfavorable to affected parties, as the IRS has sharply circumscribed the definition of "wrongful lien" under the relevant regulations. Accordingly, a § 6324 lien is a strongly protected surprise lien. *See* Sessler v. United States, 7 F.3d 1449 (9th Cir. 1993).

[72] In fact, all purchasers must be even more careful than this. They must also view all deeds in the chain of title. This is so because it is entirely plausible that an estate came into possession of the property due to the death of the individual holding the property and that the representative of the estate did not bother to "re-title" the property before transferring it to a subsequent purchaser. As such, every deed in the last ten years must be reviewed to determine whether ownership flowed through an estate. *See* Bradley Myers, *Caution Signs: Eight Things Non-estate Planning Lawyers Should Know About Estates*, OR. ST. B. BULL., Nov. 1999, at 41, 43.

[73] This risk is particularly acute given that a standard title insurance policy may not provide coverage with respect to liens not revealed in the public records. The coverage extended by a title insurance policy is determined by the contract terms of that particular policy, and many policies contain an exception that clearly removes from coverage liens not "recorded" in public records. In contrast, some policies only generically except liens that are not "reflected" in the public records. This difference in language may be material, as an estate tax lien is arguably "reflected" in the public records due to the fact that a review of the transferring deeds will show an estate on title, which should theoretically put an exceedingly cautious observer on notice. Those purchasing insurance can avoid this entirely by purchasing, at an increased price, an extended coverage policy that does not contain an exception relating to non-public liens.

[74] Every state has adopted mechanic's lien statutes that apply to private construction projects. *See* ALA. CODE §§ 35-11-210 to -431 (1999 & Supp. 2010); ALASKA STAT. ANN. §§ 34.35.050–.120 (West 2007); ARIZ. REV. STAT. ANN. § 33-981 (2007); ARK. CODE ANN. § 18-44-101 (West 2004); CAL. CONST. art. XIV, § 3; COLO. REV. STAT. ANN. §§ 38-22-101 to -133 (West 2007 & Supp. 2010); CONN. GEN. STAT. ANN. §§ 49-33 to -40a (2006); DEL. CODE ANN. tit. 25, §§ 2701–2702 (West 2006); FLA. STAT. ANN. § 713.001–02 (West 2000); GA. CODE ANN. §§ 44-14-360 to -369 (West 2003 & Supp. 2010); HAW. REV. STAT. § 507-42 (West 2008); IDAHO CODE ANN. § 45-501 (West 2006); 770 ILL. COMP. STAT. ANN. 60/1 to /39 (West 2001 & Supp. 2010); IND. CODE ANN. § 32-28-3-1 (West Supp. 2010); IOWA CODE § 572.33 (Supp. 2010); KAN. STAT. ANN. § 60-1101 (1994); KY. REV. STAT. ANN. § 376.010 (West 2006); LA. REV. STAT. ANN. §§ 9:4801– :4802 (2007); ME. REV. STAT. ANN. tit. 10, §§ 3251–3253 (2009); MD. CODE ANN., REAL PROP. §§ 9-101 to -103 (West 2002 & Supp. 2010); MASS. GEN. LAWS ANN. ch. 254, §§ 1–33 (West 2004); MICH. COMP. LAWS ANN. §§ 570.1101–1107 (West 2007); MINN. STAT. ANN. §§ 514.01–.16 (West 2002 & Supp. 2011); MISS. CODE ANN. § 85-7-131 (West Supp. 2010); MO. ANN. STAT. §§ 429.010–.360 (West 2010); MONT. CODE ANN. §§ 71-3-521 to -563 (2009); NEB. REV. STAT. ANN. §§ 52-126 to -131 (LexisNexis 2009); NEV. REV. STAT.

formed work on personal property. In the event debtors did not pay for the work performed, the lien holders could sell the property to collect payment.[75] This lien was of little value, however, if laborers gave up possession of the personalty or performed work on real property. In that case, laborers effectively lost any interest in the improvement performed and their sole recourse was to pursue a judgment.[76]

This changed, however, with the advent of the construction lien, which originated in the United States in 1791.[77] Those supplying materials for the construction of the White House had concerns about the financial stability of the new government, so Maryland lawmakers passed a law securing liens for laborers and suppliers furnishing services and materials with respect to real property construction.[78] Pennsylvania passed a similar law in 1803, and, over the next sixty years, more than thirty comparable statutes were enacted.[79]

Most state statutes provide that a lien arises in all aspects of the real property, including fixtures, when the varying aspects of work performed on the real property combine into an indivisible whole.[80] This scheme raises two primary

§§ 108.221–.222 (2009); N.H. REV. STAT. ANN. §§ 447:1– :5 (2002); N.J. STAT. ANN. §§ 2A:44-2 to :44A-3 (West 2000); N.M. STAT. ANN. § 48-2-2 (West 2003); N.Y. LIEN LAW §§ 2–3 (McKinney 2007); N.C. GEN. STAT. ANN. §§ 44A-7 to -24 (West 2000 & Supp. 2010); N.D. CENT. CODE ANN. §§ 35-27-01 to -02 (West 2008 & Supp. 2010); OHIO REV. CODE ANN. §§ 1311.01–.02 (2004 & Supp. 2010); OKLA. STAT. ANN. tit. 42, § 141 (West 2001); OR. REV. STAT. ANN. §§ 87.010–.015 (West 2003); 49 PA. CONS. STAT. ANN. §§ 1101–1301 (West 2001 & Supp. 2010); R.I. GEN. LAWS ANN. §§ 34-28-1 to -37 (West 2006 & Supp. 2010); S.C. CODE ANN. §§ 29-5-10 to -440 (2007 & Supp. 2009); S.D. CODIFIED LAWS §§ 44-9-1 to -53 (2004 & Supp. 2010); TENN. CODE ANN. §§ 66-11-101 to -103 (West 2002 & Supp. 2010); TEX. PROP. CODE ANN. §§ 53.001–.021 (West 2007); UTAH CODE ANN. §§ 38-1-1 to -3 (West 2009 & Supp. 2010); VT. STAT. ANN. tit. 9, §§ 1921–1928 (West 2007); VA. CODE ANN. §§ 43-1 to -3 (West 2001 & Supp. 2010); WASH. REV. CODE ANN. §§ 64.04.011–.021 (West 2005); W. VA. CODE ANN. §§ 38-2-1 to -2 (West 2002); WIS. STAT. ANN. §§ 779.01–.02 (West 2001 & Supp. 2010); WYO. STAT. ANN. §§ 29-2-101 to -113 (West 2007 & Supp. 2010).

[75] *See* STEVEN ANGLEY ET AL., LANDSCAPE ESTIMATING AND CONTRACT ADMINISTRATION 190 (2002).

[76] *See id.*

[77] *See* Margie Alsbrook, *Contracting Away an Honest Day's Pay: An Examination of Conditional Payment Clauses in Construction Contracts*, 58 ARK. L. REV. 353, 359 (2005); *see also* Emory Potter & Mark Duedall, *Evolving Issues in Secret Liens*, 2 DEPAUL BUS. & COM. L.J. 713, 713 (2004).

[78] Alsbrook, *supra* note 77, at 359-60.

[79] Blake Nelson, *Construction Liens: A National Review and Template for a Uniform Lien Act*, 34 WM. MITCHELL L. REV. 245, 247 (2007). These original statutes provided for liens only with respect to the construction of particular structures within specified geographic boundaries. HENRY W. FARNAM, CHAPTERS IN THE HISTORY OF SOCIAL LEGISLATION IN THE UNITED STATES TO 1860, at 155-56 (1938); LAWRENCE M. FRIEDMAN, A HISTORY OF AMERICAN LAW 178 (3d ed. 2005). The initial intent of these statutes was to encourage construction activity. *See* Nelson, *supra* at 247. However, other forces also contributed to their widespread adoption. In particular, labor movements and organizations systematically encouraged these laws as a way to support the working class. *See* FARNAM, *supra* at 155. Though not particularly consonant in purpose, these disparate forces effectively combined to spread the concept throughout America. *See id.* at 178.

[80] Nelson, *supra* note 79, at 248. It is a well-established principle that construction liens provide a lienhold interest in the entire property at issue to secure the value of each laborer's and supplier's contribution thereto. 53 AM. JUR. 2D *Mechanics' Liens* § 12 (2010).

issues: (1) what work falls within the scope of the statute and so gives rise to a construction lien; and (2) whether the statutory procedures for priority have been satisfied such that the relevant lien is perfected.[81] As to the first issue, mechanics' liens generally arise in favor of parties that provide labor, materials, equipment, and other services[82] that contribute to the improvement of real property,[83] and they generally attach to the owner's interest in the improved property.[84] It is the second issue, however, that invokes the concept of surprise liens. These liens are statutory creations, so they exist outside, or alongside, state recording acts, and do not come within the general ambit of those acts, thus enjoying whatever particular priority the legislature decided to grant to them.[85] And state legislatures grant these liens unique priority.[86]

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[81] Nelson, *supra* note 79, at 248. Courts employ strict statutory construction in determining these issues, and lien claimants must establish that they meet the requirements of the statute. *See id.* at 248-49 (citing Wind Dance Farm, Inc. v. Hughes Supply, Inc., 792 N.E.2d 79, 82 (Ind. Ct. App. 2003); Mark Twain Kan. City Bank v. Kroh Bros. Dev. Co., 798 P.2d 511, 515 (Kan. Ct. App. 1990); Lentz Plumbing Co. v. Fee, 679 P.2d 736, 744 (Kan. 1984)).

[82] *See* 53 AM. JUR. 2D, *supra* note 80, § 12. There is considerable variation from state to state with some jurisdictions broadly providing lien rights to everybody participating in the improvement of the property and others carefully distinguishing among different classes of work or different contractual relationships. Nelson, *supra* note 79, at 249-52 (discussing the various types of laborers, the varying rights accorded to them under differing statutes, and arguing for the adoption of a uniform lien act).

[83] Nelson, *supra* note 79, at 252-53. Most statutes allow liens with respect to any material or labor that improves the property; that is, anything that is used to create, alter, or improve a fixture or the real property itself. *See* 53 AM. JUR. 2D, *supra* note 80, §§ 4, 12. Again, the precise contours of what will qualify as lienable work varies by jurisdiction. Nelson, *supra* note 79, at 249-52 (examining different jurisdictions and different decisions and again arguing for the adoption of a uniform act).

[84] Nelson, *supra* note 79, at 253-56. Some jurisdictions have extended this lien to the property upon which an improved structure is located and also to any nearby land that may be necessary to the use of the improved property. *See, e.g.*, ALASKA STAT. ANN. § 34.35.055 (West 2007); CAL. CIV. CODE § 3128 (West 1993); COLO. REV. STAT. ANN. § 38-22-103(1) (West 2007); MO. ANN. STAT. § 429.010 (West 2010); OKLA. STAT. ANN. tit. 42, § 141 (West 2001); TEX. PROP. CODE ANN. § 53.022 (West 2007). The nature and location of the land may also affect the scope of the lien. *See* MINN. STAT. ANN. § 514.03(3) (West 2002); MO. ANN. STAT. § 429.010; TEX. PROP. CODE ANN. § 53.022. Similarly, the identity, authority, and ownership interest of the party authorizing the work will likely limit the right of the lienor. *See, e.g.*, Bailey v. Call, 767 P.2d 138, 140 (Utah Ct. App. 1989) (examining the right of a lessee to expose a lessor's interest to a mechanics' lien and stating that "'[s]o long as it can be found that the [contractor] performed the work at the instance of [the owner] under an express or implied contract . . . the lien is valid.'" (quoting Dugger v. Cox, 564 P.2d 300, 302 (Utah 1977) (alterations in original)).

[85] This particularity is as such when compared to the generic priority allotted real property ownership interests by state recording acts. Mechanics' lien priority is rarely thought of as outside this schema, however, because its presence is simply an accepted part of the title landscape and has long enjoyed particular statutory treatment. *But see* Michael F. Jones & Rebecca R. Messall, *Mechanic's Lien Title Insurance Coverage for Construction Projects: Lenders and Insurers Beware*, 16 REAL EST. L.J. 291, 291 (1988).

[86] Being statutory constructions, these liens must comply with applicable perfection requirements before being granted any priority. Generally, every state requires the following: (1) notice to the owner of lien rights, and (2) proper filing. Nelson, *supra* note 79, at 256. Again, these requirements vary by state. Some states do not require any notice, some require it only of prime contractors, and some require it of every party who would claim a lien. *See, e.g.*, 770 ILL. COMP. STAT. ANN. 60/21 (West Supp. 2010); ME. REV. STAT. ANN. tit. 10,

In particular, the traditional "first in time, first in right" doctrine is routinely subverted, albeit in a limited manner, by the "relation-back" doctrine. Under this concept, a properly filed and perfected mechanics' lien is deemed to have priority as of the date on which "visible, on-site construction which could be said to signal the 'commencement' of the building, erection, structure, or improvement has taken place."[87] Of course, there are significant variations in this doctrine from state to state, as the statutes themselves differ in important respects, and as interpretive common law also varies from jurisdiction to jurisdiction.[88]

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§ 3252 (2009); MD. CODE ANN., REAL PROP. § 9-104 (West Supp. 2010); MINN. STAT. ANN. § 514.011 (West 2002); WIS. STAT. § 779.02 (West 2001 & Supp. 2010). Additionally, the time and manner in which this notice must be filed, and the time in which the consequently acceptable lien may be filed, differs from statute to statute. *See* ARK. CODE ANN. § 18-44-115 (West Supp. 2010) (requiring notice before commencement of labor or furnishing of materials); IOWA CODE § 572.33(1) (Supp. 2010) (requiring notice within thirty days from commencement of labor or furnishing of materials); ME. REV. STAT. ANN. tit. 10, § 3253 (requiring notice within ninety days from the last contribution of labor or materials); N.D. CENT. CODE ANN. § 35-27-02 (West 2008 & Supp. 2010) (requiring notice fifteen days prior to filing). Mostly, the last date upon which work was performed on the property (a concept that itself varies by jurisdiction) controls the filing deadline, with deadlines therefrom varying from ninety days to eight months and some statutes discriminating based upon the status of the claimant. *See* ALASKA STAT. § 34.35.068; IND. CODE § 32-28-3-3(3)(a)(2) (West 2002 & Supp. 2010); ME. REV. STAT. ANN. tit. 10, § 3255(1); N.J. STAT. ANN. § 2A:44A-6 (West 2000); N.M. STAT. ANN. § 48-2-6 (West 2003); N.D. CENT. CODE ANN. § 35-27-13; N.Y. LIEN LAW § 10(1) (McKinney 2007); WYO. STAT. ANN. § 29-2-106(a) (West 2007 & Supp. 2010).

87 Mich. Roofing & Sheet Metal, Inc. v. Dufty Rd. Props, 298 N.W.2d 923 (Mich. Ct. App. 1980) (citing Michigan mechanics' lien law). Relation back to the start of "visible" construction is a common statutory provision throughout the country. *See* ALA. CODE § 35-11-211 (1991) ("Such lien as to the land and buildings or improvements thereon, shall have priority over all other liens, mortgages or incumbrances created subsequent to the commencement of work on the building or improvement."); CONN. GEN. STAT. § 49-33(b) (2006) ("The claim is a lien on the land, building and appurtenances or lot or in the event that the materials were furnished or services were rendered in the site development or subdivision of any plot of land, then on the plot of land and the claim takes precedence over any other encumbrance originating after the commencement of the services, or the furnishing of any such materials . . . ."); KAN. STAT. ANN. § 60-1101 (1994) ("The lien shall be preferred to all other liens or encumbrances which are subsequent to the commencement of the furnishing of such labor, equipment, material or supplies by such claimant at the site of the property subject to the lien."); KY. REV. STAT. ANN. § 376.010(1) (West 2006) ("The lien on the land or improvements shall be superior to any mortgage or encumbrance created subsequent to the beginning of the labor or the furnishing of the materials, and the lien, if asserted as hereinafter provided, shall relate back and take effect from the time of the commencement of the labor or the furnishing of the materials."); MICH. COMP. LAWS ANN. § 570.1119(2) (West 2007) ("A construction lien under this act shall take priority over all garnishments for the contract debt made after commencement of the first actual physical improvement, without regard to the date of recording of the claim of lien."); UTAH CODE ANN. § 38-1-5 (West 2004) ("The liens herein provided for shall relate back to, and take effect as of, the time of the commencement to do work or furnish materials on the ground for the structure or improvement, and shall have priority over any lien, mortgage or other encumbrance which may have attached subsequently to the time when the building, improvement or structure was commenced, work begun, or first material furnished on the ground . . . .").

88 *See* statutes cited *supra* note 87.

The relevant point, however, is that this relation-back concept means mechanics' liens can be surprise liens. By permitting a lien to relate back to the time of visible work or commencement, this doctrine creates a "dark period." This dark period does not expire until a potential lienor's right to file expires such that a non-filed lien may ultimately be deemed to attach at the commencement of construction and thus be given priority over a subsequent bona fine purchaser.[89] The ostensible justification for this is to give contractors, laborers, and material suppliers assurance that they will be protected from the first time that they aid in the improvement of the property, but to balance this protection against the interests of subsequently interested parties who can protect themselves by visibly inspecting the property.[90] The potential for a surprise mechanics' lien is large, however. Many, if not most, real estate transactions involve some type of improvement or alteration to the relevant property, so potential purchasers or secured parties must routinely confront the potential for surprise liens created by these statutes.[91]

B. A Troubling Trend

This judicial and legislative acceptance and encouragement of surprise liens constitutes a little-noticed, and troubling, trend. Both the estate tax lien and the relation back feature of mechanics' lien laws demonstrate an explicit willingness on the part of lawmakers to craft exceptions to real property recording acts and the notice attributes widely believed to flow from them.

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[89] Some states have closed this dark period by cutting off a lienor's rights upon a bona fide purchase unless the purchaser had notice of the work performed. *See* MINN. STAT. ANN. § 514.05; ME. REV. STAT. ANN. tit. 10 § 3255(2).

[90] *See* Edgar N. Durfee, *Priorities*, 57 MICH. L. REV. 459, 476-477 (1959). *See also* Wineberg v. Moore, 194 F. Supp. 12, 16-17 (N.D. Cal. 1961) (discussing California common law regarding due diligence and constructive notice); *infra* Part IV.

[91] *See* Jones & Messall, *supra* note 85, at 296-97. Therein, the authors discuss in detail the manner in which the title insurance industry has attempted to address the issue of surprise mechanics' liens that exist at the time the policy is issued, but do not gain visible priority until a later time. Among other things, they may do so by specifically excluding coverage for mechanics' liens

> arising from an improvement on the land contracted for and commenced subsequent to [the date the policy is issued and] not financed in whole or in part by proceeds of the indebtedness secured by the insured mortgage which at [the date the policy is issued] the insured has advanced or is obligated to advance.

Id. at 296 (quoting the 1970 policy form). Such an exclusion speaks to work performed after the date the policy is issued. *Id.* at 296-97. Moreover, while an extended lender's title policy will cover mechanics' liens of this nature, standard policies will not. Telephone interview with Jeffrey J. Jensen, President, Landmark Title Company (April 23, 2010). An owner's policy does have broader coverage, but even these policies contain language that arguably provides cover to insurers. *Id.* In particular, a standard coverage ALTA policy excludes matters not revealed by a review of the public records. *See* AMERICAN LAND TITLE ASS'N, OWNER'S POLICY, EXCLUSION FROM COVERAGE 3(b) (2006) http://www.alta.org/forms/index%20wide%20open.cfm (follow "ALTA Owner's Policy" hyperlink). This arguably removes all responsibility for a mechanics' lien. *See, e.g.*, Hon Realty Corp. v. First Am. Title Ins. Co., 291 Fed. App'x. 951, 953 (11th Cir. 2008) (holding that an encumbrance against title holder's property was not covered by title insurance because it was not reflected in public records at date of issuance of insurance).

The justification behind these liens, in particular, suggests that the long-standing statutory notice requirements discussed above are giving way to an *ad hoc* series of normative decisions by judges and legislators as to whose interests are most consistent with the greater economic interests of society as a whole.[92] One possible reason for this is the stand-alone nature of real property recording acts. They act as "background" legislation that provides a general rule that is easily subjected to state exceptions or federal preemptions. They are also among the oldest and most accepted series of statutes in America,[93] and the generally non-controversial nature of their language and effect permits incremental encroachments to take effect with little controversy or psychological impact.

Whatever the reason, the two liens identified above are historically recent constructs[94] that are symbolic of a growing trend toward accepting surprise liens.[95] These liens are new and are assuming a more significant role in modern real estate law. The potential reasoning behind this, and a critical analysis of that reasoning, is set forth below.

IV. Justifications for Surprise Liens

Why does the law increasingly condone surprise liens, in contravention of the generally accepted standards and beliefs fostered by the historically general application of state recording acts? This section examines three potential justifications. Two of these—inefficiency of notice filing and disutility of notice systems—have partial analogues in the context of hidden liens affecting personal property and have been the subject of substantial analysis in that context.[96] The third is put forward here for the first time and is based upon the apparent economically favored status of the lienor. Existing academic criticism and a new application of the lessons learned from the recent financial crisis effectively discredit the first two of these justifications. This leaves lienor status as the true basis for this rising trend—a conclusion with a number of potentially troubling implications.

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92 *See infra* Part IV.

93 *See supra* Part II.B.

94 *See* Detroit Bank v. United States, 317 U.S. 329, 331, 335 (1943) (establishing the estate tax lien as a surprise lien); McConnell v. Mortg. Inv. Co. of El Paso, 305 S.W.2d 280, 282-83 (Tex. 1957) (discussing the relatively recent genesis of mechanics' liens as surprise liens).

95 This trend, growing from its historical roots in maritime and forfeiture law, represents an accelerating acceptance of these types of liens. *See* Gary F. Seitz, *Interaction Between Admiralty and Bankruptcy Law: Effects of Globalization and Recurrent Tensions*, 83 Tul. L. Rev. 1339, 1358-59 (2009) (discussing maritime liens); Edward E. Sterling, *Responding to the Risks of Forfeiture (With Form)*, *in* Current Developments in Title Insurance 445, 450 (Practising Law Institute ed.,1992) (discussing the history of "relation back" as it relates to forfeiture and demonstrating the numerous instances wherein this concept has now been statutorily accepted). *See also In re* Parr Meadows Racing Ass'n, 880 F.2d 1540, 1546-48 (2d Cir. 1989) (indicating that a New York county's real property tax lien related back to a prior date).

96 *See generally* Lipson, *supra* note 9, at 474-92. Professor Lipson generally argues that the law is increasingly abandoning notice-filing requirements applicable to personal property.

A. *Inefficiency of Notice Filing*

The study of law and economics provides a potentially useful explanation as to why the law permits surprise liens,[97] and there has been significant analysis utilizing this paradigm to attempt to determine whether secured credit and notice filing are efficient.[98] Broadly speaking, economic analysis of the law is an approach to legal jurisprudence that applies microeconomic theories, such as cost-benefit analyses, to legal issues.[99] From a positive perspective, this can be utilized generally to explain the development and current state of the law regarding surprise liens.[100] In this context, the question of why lawmakers increasingly leave competing interest holders to their own devices is one that centers on whether the government (in the form of real property recording acts) or the free market (in the form of private contracts) will reach a better result. The essence of this question, in turn, is whether the current system of real estate lending and purchasing, as currently constructed around a publicly available structure permitting both filing and review, is economically justifiable.[101]

The general nature of this examination is not new. In particular, the Modigliani-Miller Theorem (the M-M Theorem) has been the subject of substantial analysis and application in this context[102] and may suggest that the concept of security and its concomitant notice filing may add little benefit to society.[103] Broadly speaking, the M-M Theorem states that, in a perfect market, extraordinary or special returns of capital cannot be generated by unique or specialized capital structures.[104] The thinking is as follows: if a debtor grants a security interest in its assets to incentivize a lender to make a loan to it, other potential creditors will charge more, due to the increased risk associated with lending to a debtor whose assets are already encumbered.[105] Whatever cost the debtor might save by granting a security interest to the first creditor, or whatever other

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97 *See* Richard A. Epstein, *Law and Economics: Its Glorious Past and Cloudy Future*, 64 U. Chi. L. Rev. 1167, 1168-69 (1997). This mode of analysis began to gain widespread credibility in the early 1960s, based largely on the work of Ronald Coase and Guido Calabresi. *See generally* R.H. Coase, *The Problem of Social Cost*, 3 J.L. & Econ. 1 (1960); Guido Calabresi, *Some Thoughts on Risk Distribution and the Law of Torts*, 70 Yale L.J. 499 (1961).

98 *See generally* Thomas H. Jackson & Anthony T. Kronman, *Secured Financing and Priorities Among Creditors*, 88 Yale L.J. 1143 (1979); David Gray Carlson, *On the Efficiency of Secured Lending*, 80 Va. L. Rev. 2179 (1994); Steven L. Schwarcz, *The Easy Case for the Priority of Secured Claims in Bankruptcy*, 47 Duke L.J. 425 (1997).

99 Stephen M. Bainbridge, Corporation Law and Economics 18-19 (2002).

100 Normative law and economics, on the other hand, makes prospective policy recommendations based on economic consequences. *See* Richard A. Posner, *The Economic Approach to Law*, 53 Tex. L. Rev. 757, 768 (1975).

101 *See* Jackson & Kronman, *supra* note 98, at 1146-48.

102 *See, e.g.*, Royce de R. Barondes, *Fiduciary Duties of Officers and Directors of Distressed Corporations*, 7 Geo. Mason L. Rev. 45, 75 n.98 (1998). *See generally* Paul M. Shupack, *Solving the Puzzle of Secured Transactions*, 41 Rutgers L. Rev. 1067 (1989) (applying economic analyses to secured transactions).

103 *See* Franco Modigliani & Merton H. Miller, *The Cost of Capital, Corporation Finance and the Theory of Investment*, 48 Am. Econ. Rev. 261, 261-62 (1958); Eugene F. Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. Fin. 383, 383 (1970).

104 *See* Modigliani & Miller, *supra* note 103, at 261-62.

105 Lipson, *supra* note 9, at 475-76.

benefit he might garner from such an arrangement, is subsequently nullified by the increased cost charged by later lenders.[106] In other words, risk and return calculations must be viewed across the complete chronological spectrum of an enterprise, momentary attempts to alter or minimize current costs are ultimately irrelevant, and a firm's market value is ultimately independent of its capital mix.[107] Essentially, the M-M Theorem posits that secured credit is not necessary to maximize a firm's market value.

The wide acceptance of the M-M Theorem as a building block of financial principle[108] has led economic and legal theorists to suppose that traditional filing systems that are fundamentally embedded in a system of secured credit, such as the recording acts, make little economic sense.[109] These systems are designed to instill confidence in purchasers and bolster secured credit by allowing creditors to confidently predict their interest in the collateral. If secured credit is not an essential element for efficient allocation of capital, however, a filing system is of questionable value, and this is particularly so given that filing systems have some clearly negative consequences.[110]

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[106] *Id.*

[107] Modigliani & Miller, *supra* note 103, at 268-69. The Efficient Markets Hypothesis presents an economic analogy in the context of investment decisions. This hypothesizes that all public information is immediately reflected in stock price as soon as such information enters an efficient market. Fama, *supra* note 103, at 383. Accordingly, above-average returns are not possible based upon public information, and, even if they were momentarily available, the market would immediately adopt the utilized method and so erode its value. *See* Eugene F. Fama, *Random Walks in Stock Market Prices*, 51 FIN. ANALYSTS J. 75, 76 (1995). As applied to a secured financing system that utilizes, or is based upon, publicly available information, a reduced interest rate afforded by a secured creditor will immediately be offset by an increased interest rate demanded by a later creditor based upon the now-increased risk of lending to an encumbered debtor.

[108] *See, e.g.*, Douglas G. Baird, *The Importance of Priority*, 82 CORNELL L. REV. 1420, 1422 (1997) ("The bedrock of modern corporate finance is the Modigliani and Miller indifference proposition.").

[109] *See* Lipson, *supra* note 9, at 476-78.

[110] These negative consequences include the creation of negative externalities and the outright cost of such a system. As to negative externalities, there is an argument that secured credit actually fosters the very sort of harm, exposing creditors to undue risk, it is meant to prevent by permitting debtors and sophisticated creditors to effectively cooperate to transfer risk to less sophisticated parties and thus ultimately engenders distorted economic arrangements. *See* Lucian Arye Bebchuk & Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy*, 105 YALE L.J. 857, 864 (1996). This view posits that there are many types of unsophisticated or non-intentional creditors, called "nonadjusting creditors," that cannot, or do not, demand higher interest rates in response to an effectively inferior position behind secured creditors. *Id.* at 864-65. The result of this imbalance of perception or action is that debtors have a decreased incentive to monitor the type of generalized risk that would most affect unsecured creditors because they do not pay a true price for it. *Id.* at 934. This potential distortion of behavior is arguably heightened by a notice filing system, which gives nonadjusting creditors an outsized belief that they are adequately protected. Such a view—essentially equivalent to believing that, because everyone else has adequate information, everyone else is behaving appropriately and thus may serve as a model for behavior—is a type of "pluralistic ignorance" wherein individual members of a group privately reject a norm but assume everyone else accepts it and act accordingly. Sandeep Gopalan, *Say on Pay and the SEC Disclosure Rules: Expressive Law and CEO Compensation*, 35 PEPP. L. REV. 207, 215 (2008). Such tacit belief ironically deepens the lack of appropriate activity on the part of such creditors. As to outright cost, there is a

There have been various explanations and responses attempting to address this skepticism, but these are not without significant theoretical weaknesses. At best, they constitute a tepid endorsement of traditional filing systems.[111] These

substantial direct cost associated with the filing systems required by the reporting acts. This is because many of these systems have filing fees and ultimately serve as direct revenue streams for county and other local governments. *See, e.g.*, Lipson, *supra* note 9, at 484-85. To the extent, then, that these acts and the notice provisions they assure do not benefit anyone, they constitute simple rent seeking by governmental entities ever eager for more revenue. This would not be an original scheme. Some of the earliest statutes relating to the recordation of transfers of title to real property have been supposed to be largely, if not primarily, motivated by Henry VIII's desire for income. *See* James W. Bowers, *Of Bureaucrats' Brothers-in-Law and Bankruptcy Taxes: Article 9 Filing Systems and the Market for Information*, 79 MINN. L. REV. 721, 731-32 (1995); *see also supra* note 28.

[111] One potential explanation for the ongoing existence of secured lending, and its attendant notice systems, is that incurring secured credit acts as an efficient method for the debtor to "signal" to third parties that a company believes it enjoys good prospects. *See generally* Alan Schwartz, *Security Interests and Bankruptcy Priorities: A Review of Current Theories*, 10 J. LEGAL STUD. 1, 17 (1981) [hereinafter Schwartz, *Security Interests*]; F.H. Buckley, *The Bankruptcy Priority Puzzle*, 72 VA. L. REV. 1393 (1986); Alan Schwartz, *A Theory of Loan Priorities*, 18 J. LEGAL STUD. 209 (1989) [hereinafter Schwartz, *Loan Priorities*]. In other words, secured lending does not benefit potential creditors by providing security so much as it imparts critical information about potential debtors to potential creditors. This theory is somewhat impractical, however, as it assumes that creditors have perfect knowledge of debtor risk appetite and ignores the substantial ambiguity that exists among the signals that would be sent. Schwartz, *Security Interests*, *supra* at 17-18. This critical view of the ability of a notice filing system to impart notice has been significantly advanced in the very economic literature that has aired its potential existence and value. *See id.* Schwartz's *Loan Priorities* article discusses the issue in terms of security interests attaching to personal property, but this analysis is applicable to real property notice filing and the issues discussed in this Article. Therein, the author criticizes the potential value of the kind of signaling a notice filing system might provide by theorizing about the ideal capital structure rational parties would choose in an environment with perfect information. *See* Schwartz, *Loan Priorities*, *supra* note 111, at 222. Schwartz reviewed various forms and guides that provide examples of secured financing documents and found a high incidence of covenants forbidding or restricting later borrowing in general and securitization of debt in particular. *Id.* at 216-18. The author's experience with loan documents prepared by banks and other sophisticated creditors anecdotally supports this view; such creditors systematically impose significant restrictions on future activities and accompany such restrictions with complementary representations and warranties and material, ongoing reporting requirements. From the widespread existence of such covenants, Schwartz concluded that theoretical lending relationships would consistently afford creditors a rigid first-in-time priority wherein the first creditor would generally enjoy priority over all later lenders. *See id.* at 213-19. From there, Schwartz theorized as to how creditors (in a hypothetical environment without notice filing systems) would become aware of a first creditor's first position. *See id.* at 219. His answer is that debtors would be incentivized to properly and fully inform third party creditors to lessen their cost of capital. *See id.* This incentive would arise because rational lenders would assume that a material portion of all debtors are poor credit risks and would systematically demand a high interest rate, which generalized demand would cause good debtors without prior debt or securitization to advertise themselves so that they could avoid paying such high rates. *Id.* at 220. Such advertising could occur on financial statements in the context of the type of financial accounting (or lack thereof) associated with debt or on publicly reported disclosures, if required by governmental rules and regulations. *Id.* at 220-21. Regardless of the specific mode of communication, Schwartz argued that the type of incentivized private disclosure he had identified was "both cheap and common" such that existing modes of notice filing were unduly expensive and unnecessary with respect to the extension of credit. *Id.* at 222. Schwartz examined, and ultimately disregarded, the danger of surprise

economic analyses and hypotheses, then, remain as theoretical criticisms of secured credit, in general, and notice filing, in particular.[112] Given the current high regard in which economic analysis is held, and the widespread acknowledgment of the theoretical underpinnings of these views, it is entirely conceivable that these criticisms have taken on a normative aspect and influenced legislative and judicial lawmakers to either ignore existing discontinuities in notice-provision systems or actively encourage them.[113]

B. *Disuse of Notice Filing*

Another argument against notice filing (and, as such, a potential justification for the ongoing acceptance of surprise liens) is that potential users do not actually utilize the system.[114] With respect to potential creditors, recording

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liens in such a true first-in-time system, logically extending his perception of debtors' incentive to fully communicate with potential creditors. Such a desire and need for systemic and adequate communication on an ongoing basis throughout the lifespan of an organization would increase the difficulty of fraudulently hiding superior, undisclosed liens from searching and perceptive creditors and would ultimately disincentivize any chicanery as such behavior would inevitably affect subsequent opportunities and costs. *See id.* at 224. Effectively, then, Schwartz acknowledges a potential explanation for the ongoing vitality of notice filing systems in credit markets in the face of the M-M Theorem but ultimately discards that explanation and, in fact, deepens the existing economic criticism of filing systems. Such systems are inefficient and unnecessary because the market, fueled by rational incentives and choices, would more cost effectively disclose the existence of liens. *See id.* at 224-25.

[112] The focus of this economic analysis upon the efficacy of securitized lending transactions, as opposed to purchasing transactions, does not lessen its potential impact on the perception and treatment of notice filing systems in general. First, animosity toward secured lending necessarily bleeds into negativity toward filing systems, even if they could theoretically continue to serve a purpose with respect to purchasing transactions. *See, e.g.*, Schwartz, *Loan Priorities*, *supra* note 111, at 223 (suggesting that economic incentives would regulate creditor-debtor issues but that filing systems could be retained in order to address conflicts relating to later buyers). Thus, even if such criticisms only relate to one of the primary roles of a notice filing system, such a view would inevitably lead to deemphasizing the importance of notice systems and their purported goals. Second, these criticisms apply just as forcefully to purchasing transactions. The M-M Theorem posits that a company's capital structure is ultimately irrelevant because creditors will demand higher interest rates if prior investors are in a secured position. This, in turn, leads to the supposition that debtors will be sufficiently incentivized to provide adequate information to creditors such that a government-run system of reporting lending security interests is unnecessary and inefficient. The same can be said of a purchasing transaction. In the same sense that a creditor should demand a higher interest rate if a debtor's assets are encumbered, a buyer should demand a lower price if the subject asset is encumbered. As above, this generic demand for a superior financial situation should incentivize sellers to render full and complete information to prospective purchasers. The vehicle for providing such information could be a recording scheme, such as those currently in place, or a series of contractual undertakings or indemnities. In any event, such an economically driven type of voluntary disclosure would moot any legal rules or requirements addressing surprise liens. *See* Alex M. Johnson, Jr., *An Economic Analysis of the Duty to Disclose Information: Lessons Learned from the Caveat Emptor Doctrine*, 45 SAN DIEGO L. REV. 79, 123-125 (2008) (arguing that the doctrine of caveat emptor is reemerging in the sale of real estate with respect to physical defects due to potential informational symmetry).

[113] *See* RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 25, 27 (Aspen Publ'g, Inc. 5th ed. 1998) (1972).

[114] *See* Lipson, *supra* note 9, at 486-90.

acts should convey valuable information regarding the current standing and potential prospects of debtors, and, consequently, of the price of credit that creditors should charge. Some have suggested, however, that very few unsecured creditors ever bother to examine publicly available notice records, notwithstanding the theoretical value inherent therein.[115]

These types of creditors are referred to as "non-reliance creditors" and include service and materials providers who interact with companies in an ongoing manner (such as accountants, lawyers, utilities providers, etc.).[116] It is precisely these types of creditors—those who will never, or rarely, become secured and will thus rely on the general reliability and creditworthiness of a debtor—who logically stand to gain by examining the capital structure of a debtor, but they seem not to do so.

An explanation for this apathy is that many of these types of small creditors assume and hope that they will be paid from income produced in the ordinary course of business. Thus, they make the rational decision that the type of due diligence associated with adequately examining notice records (such as a county recorder's records) does not provide a benefit justifying the cost.[117] Such creditors rely on other pressures and on the general, observable quality of the debtor's business to ensure repayment.[118]

This lack of utility in a lending context creates a theoretical pressure upon courts and legislatures to assign less importance and consequence to notice systems, in general, and recording acts, in particular, which ultimately demeans concern about surprise liens.[119] The same theoretical pressures exist in the buying and selling context, although for different reasons.

In addressing the importance of conveying good title, modern real estate transactional law has moved away from a singular reliance on title insurance, which is based upon the notice systems fostered by the recording acts, and toward contractual and common law obligations upon lenders and sellers to provide good title.[120] To be sure, one of the first steps of any modern real

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[115] *Id.*

[116] *See* White, *supra* note 51, at 827-29.

[117] *See* Lynn M. LoPucki, *The Unsecured Creditor's Bargain*, 80 VA. L. REV. 1887, 1923-24 (1994).

[118] *Id.* at 1941.

[119] This supposed lack of utility is not complete, of course. Even in examining the perhaps counterintuitive failure of simple creditors to utilize notice systems, most have acknowledged that a still significant section of the credit community will continue to rely upon, and benefit from, such a system. Lipson, *supra* note 9, at 488. This more sophisticated type of creditor is one that is more likely to extend secured credit and that will certainly pay for title insurance and UCC filing reports. Thus, the argument is not that all notice-filing systems are incorrigibly useless. *Id.* at 488-90 (discussing additional weaknesses in the argument that notice filing systems are not used enough to justify their cost, including a lack of empirical evidence for the argument; anecdotal evidence of such usage, even by less sophisticated creditors; and the indirect usage of such systems by such creditors through reliance on credit reporting services that do, themselves, use such systems). Nevertheless, this is an additional pressure, wrought in an economic cost-benefit analysis that theoretically provides cover to lawmakers to suffer the existence of surprise liens.

[120] The author bases this claim largely on personal experience and on extended conversations with colleagues and associates, all of whom note that this is a standard element of any modern commercial transaction involving real property. *See also, e.g.*, Gregory G. Gosfield,

estate transaction is to pull a title report (almost always provided by a title insurance company and based exclusively on public records) and examine it carefully, searching for any hiccup or discontinuity of title.[121] However, another one of the first steps of that same transaction is to assiduously negotiate over the covenants, warranties, and representations the seller will undertake and make in connection with the sale.[122] Among these are almost invariably numerous undertakings relating to title; sellers, as a matter of course, contractually guarantee that good title will be conveyed.[123]

It is tempting to view these covenants and warranties merely as support for, or "back up" to, the explicit insurance issued by a title insurer, but these covenants and warranties are often of prime importance. This is because title insurers are generally subrogated to the rights of their insured counterparty.[124] Accordingly, the title insurer protects the immediate purchaser but ultimately seeks to transfer the cost of a title defect to the contractually bound party. The ultimate protection against such a defect, then, is the covenant or warranty entered into or assumed by the seller and not the notice provided by real property records.[125]

This growing apathy to such records and their importance to buyers and creditors is further demonstrated by the recent advent of the Mortgage Electronic Registration System (MERS). MERS is a privately owned and operated

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A Primer on Real Estate Options, 35 REAL PROP. PROB. & TR. J. 129, 155 (2000) (indicating that a warranty of good title is a standard term in a bilateral real estate contract).

121 *See, e.g.*, JAY D. MUSSMANE, PURCHASE/SALE OF RESIDENTIAL PROPERTY, at ch. VI (2008).

122 *See id.* at 155.

123 This may occur either through a warranty and representation that explicitly survives the consummation of the transaction, in accepted contravention of the common law doctrine of merger, or in connection with the various covenants associated with various types of deeds. *See, e.g.*, Charles B. Sheppard, *Assurances of Titles to Real Property Available in the United States: Is a Person Who Assures a Quality of Title to Real Property Liable for a Defect in the Title Caused by Conduct of the Assured?*, 79 N.D. L. REV. 311, 322-23 (2003) (indicating that a transferor under a warranty deed undertakes the following six covenants of title: (1) the covenant of seisin, (2) the covenant of the right to convey, (3) the covenant against encumbrances, (4) the covenant of warranty, (5) the covenant of quiet enjoyment, and (6) the covenant of further assurances). These covenants inhere both in general warranty deeds and in special warranty deeds, though they are, in the latter case, deemed to run from the transferor only as to its own conduct—that is, the covenants do not cover title defects that exist due to the acts of a predecessor to the transferor. *Id.* Of course, not all sales involve warranty deeds or full guaranties of title. However, these transactions (often consummated with a quitclaim deed) generally involve explicitly compromised property and are priced accordingly.

124 *See* John D. Hastie, *Real Estate Acquisition, Development and Disposition from the Developer's Perspective*, *in* ALI-ABA COURSE OF STUDY: MODERN REAL ESTATE TRANSACTIONS, Aug. 13-15, 2009, at 40 (2009).

125 Interestingly, this is what one would expect under the M-M Theorem—although a system of title insurance based upon the information made available in publicly available documents may have some function (here, as a mechanism for buyers to purchase a streamlined ability to claim contractual rights), the true incentive to disclose title defects is with the seller, who contractually undertakes to bear the cost of not having done so. *See supra* Part IV.A.

database that tracks ownership and assignments of mortgages.[126] Beginning in the 1990s, the mortgage industry began to evolve to more widely spread the risks incurred by, and benefits flowing to, mortgagees.[127] One aspect of this evolution was to separate the servicing of loans from the ownership of loans and to separate the ownership of loans from the holder of the note.[128] Under traditional restrictions, these innovations could cause significant difficulties. Historically, every time ownership of a mortgage loan was sold or transferred, the parties had to prepare and record an assignment of the accompanying security instrument to be recorded in the recording office where the real estate securing the loan was located.[129] This was cumbersome, expensive, and often caused confusion and chain of title problems.[130]

MERS was developed, in part, in response to these problems and in order to streamline this process and simplify the steps required in connection with it.[131] In effect, it eliminated the need to draft and record a new assignment each time a loan was sold, traded, or securitized, by creating a privatized, internal system that tracked this information for its members.[132] Lenders and other participants—MERS members—pay an annual fee and sign a contract with MERS wherein they agree to abide by rules and restrictions promulgated by MERS, and to appoint MERS as their agent with respect to registered mortgages.[133] MERS is listed as the mortgagee of record, and members can thereafter buy and sell these registered mortgages among themselves without publicly recording them, transferring the mortgages via MERS internal records pursuant to contractually binding contracts.[134] MERS remains as the nominee for the new owner, regardless of how many different times the mortgage is pooled, dissected, or sold.[135] The recorded mortgage is never assigned on public records, and the originally recorded mortgage retains its priority position pursu-

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126 Beau Phillips, *MERS: The Mortgage Electronic Registration System*, 63 CONSUMER FIN. L. Q. REP. 262, 263 (2009).

127 *See id.* at 262.

128 *Id.* The latter innovation is often associated with dividing the ownership of a loan, or a pool of loans, among various owners. In such a situation, because there are multiple owners of the same obligation, there is no manner in which all owners can hold the note. This often occurs in connection with the packaging of a mortgage into a mortgage-backed security for sale to investors, none of whom ever hold the note, or even know who the borrower actually is. *See, e.g.*, Kurt Eggert, *Held up in Due Course: Predatory Lending, Securitization, and the Holder in Due Course Doctrine*, 35 CREIGHTON L. REV. 503, 546-48 (2002) (indicating the diversified and anonymous nature of the borrowers represented in mortgage backed securities transactions).

129 *See Mortgages: MERS and Foreclosures*, REAL EST. L. REP., Oct. 2009, at 1, 1.

130 *See id.* Multiple assignments, particularly of the same instrument to different parties, may complicate title searches or even prevent a title insurance company from issuing title insurance. Additionally, the recording costs can quickly add up. Recording costs for an assignment often starts at $15-$30 for the first page and continues at $2-$3 per page thereafter. Phillips, *supra* note 126, at 263.

131 *See* Phillips, *supra* note 126, at 263.

132 *See id.* at 263-64.

133 *Id.*

134 *Id.*

135 *Id.*

ant to local recording laws.[136] The entire process is without cost and remains unknown outside the MERS system. This system has grown exponentially in fifteen years since its creation, and MERS claims that it is now the nominal mortgagee on up to two-thirds of new residential loans in the country.[137]

MERS developed as a private-market response to perceived problems and costs associated with the current public system, and represents a significant detachment from real property notice filing, as it is commonly perceived. This calls into question the extent to which individuals and entities at every stage of potential interest and concern—buyers, sellers, and creditors—can rely on, or desire to rely on, the notice system currently in effect.[138]

These are indications that our notice filing systems are increasingly falling into disuse. Whether a result of passively ignoring available information, contracting away the need to rely on notice systems, or a massive and recent innovation meant to permit parties to avoid recording real property records, this generic dissatisfaction and disuse of notice filing systems undermines the usefulness and utilization of our public recording system, and it may contribute to the growing judicial and legislative acceptance of surprise liens that exist in derogation thereof.

C. Lienor Identity

Another argument that may underlie the existence and emerging trend toward the acceptance of surprise liens, presented herein for the first time, is that certain lienors should enjoy favored status because granting such status to these classes of creditors creates socio-economic benefit. Based upon an examination of much of the authority that has passed upon, and permitted or excused surprise liens, it appears clear that most courts and legislators are motivated by a belief that those possessing surprise liens are more deserving of rights than are good-faith purchasers.

With respect to the estate tax lien, recall that the seminal case establishing the surprise nature of this encumbrance is *Detroit Bank v. United States*.[139] As discussed above, the U.S. Supreme Court held that that the estate tax lien imposed by the predecessor to § 6324 is not subject to any lien filing requirements.[140] This reasoning, however, is strained.

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136 This arrangement is sufficient in case of foreclosure as well. Under common law, as a nominee, or under the Uniform Commercial Code, as a transferee or as a holder of a note indorsed in blank, MERS has standing to bring a foreclosure on behalf of the owner or owners of a note in default. *See, e.g.*, Mortg. Electronic Registration Sys., Inc. v. Foster, No. 2004-3956 (Fla. 4th Jud. Cir. Ct. Dec. 17, 2004); Mortg. Electronic Registration Sys., Inc. v. Azize, 965 So. 2d 151, 154 (Fla. Dist. Ct. App. 2007).

137 *See Mortgages: MERS and Foreclosures*, *supra* note 129, at 1; *see also* Phillips, *supra* note 126, at 264.

138 Indeed, it has been argued that MERS does harm to "the accuracy of the *public* land and court records databases, establishing in their place a *proprietary* national electronic registry system that 'tracks' beneficial ownership and servicing rights and whose information is inaccessible to the public." *See* Brief of *Amici Curae* South Brooklyn Legal Services et al. at 4, MERSCORP, Inc. v. Romaine, 861 N.E.2d 81 (N.Y. 2006) (No. 2004-04735).

139 Detroit Bank v. United States, 317 U.S. 329 (1943).

140 *Id.* at 337.

To reach its conclusion, the Court relied on its interpretation of the IRC's provision that explained when filing was necessary.[141] The Court explained that the filing requirement was set forth in a different statute that did not explicitly refer to the estate tax lien and that, as such, there was no indication that Congress had wanted the filing requirement to apply to the estate tax lien.[142] However, this requirement of a direct reference is nowhere in the relevant statutory scheme, and is, in fact, contradicted by the language of the statutes at issue. Section 6323(a) provides that "[t]he lien imposed by section 6321 shall not be valid as against any purchaser, holder of a security interest, mechanic's lienor, or judgment lien creditor until [properly filed]."[143] Section 6321 provides that, "[i]f *any person* liable to pay *any tax* neglects or refuses to pay the same after demand, the amount . . . shall be a lien in favor of the United States upon all property and rights to property, whether real or personal, belonging to such person."[144] On its face, § 6321 is unambiguous: it refers to "any tax." Because the estate tax is a tax, the Court could have concluded that estate tax liens are subject to the filing requirement in § 6323(a).

Why, then, did the Court adopt its alternative reading of the statute? To some extent, the Court's reasoning might be attributable to the historical tension between federal and state law.[145] The Court might have been concerned about imposing state filing requirements on a federal entity, the IRS. However, that tension ostensibly was resolved in favor of filing by the adoption of § 6323, so it seems likely that there is a deeper strain of reasoning behind courts' seeming unwillingness to hold the federal government to an apparently clear filing requirement.

The answer may lie in the ancient rule of *nullum tempus occurrit regi,* which means that "no time runs against the king." The rule is primarily applied in American jurisprudence to prevent statutes of limitation and the doctrine of laches from running against governmental entities.[146] Although the original

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[141] *Id.* at 335-37.

[142] *Id.*

[143] I.R.C. § 6323(a) (2006).

[144] I.R.C. § 6321 (emphasis added).

[145] There was a lag time between the imposition of federal tax liens and the requirement that these liens be recorded to be effective. *See Detroit Bank*, 317 U.S. at 334 (noting that the tax lien was imposed in 1866 and that the filing requirement was imposed in 1913). Due to the preemption doctrine arising from the Supremacy Clause of the Constitution, this lack of a filing requirement defeated the states' recording laws. *See, e.g.*, United States v. Vohland, 675 F.2d 1071, 1074 (9th Cir. 1982) ("Unless a federal statute requires a government tax lien to be recorded, the unrecorded lien may be enforced against subsequent transferees.").

[146] *See* United States v. Hatfield, No. 94-50397, slip op. at 3 (N.D. Ill. April 2, 1996). "The U.S. Supreme Court has long held that '[w]hen the United States becomes entitled to a claim, acting in its governmental capacity and asserts its claim in that right, it cannot be deemed to have abdicated its governmental authority so as to become subject to a state statute putting a time limit upon enforcement.'" *Id.* (quoting United States v. Summerlin, 310 U.S. 414, 417 (1940); Chesapeake & Del. Canal Co. v. United States, 250 U.S. 123, 125 (1919)). This rule is derived from the rights of the English monarch, and, thereunder, "the United States is not bound by state statutes of limitations or subject to the defense of laches in enforcing its rights absent a clear manifestation of intent by Congress that the government be so bound." *Id.*

reasoning behind this rule is antiquated,[147] it has continuing application and vitality in the deeply rooted "public policy of preserving public rights, revenues, and property from injury and loss, [resulting from] the negligence of public officers."[148] In other words, the courts are chary of the "public fisc," even if such protection effectively ignores long-accepted principles that apply to private parties.[149] This might explain the willingness of the *Detroit* Court to elide the language of the federal tax lien filing statute: unless the federal government specifically exposes itself to a procedural or substantive impediment—even one as basic and widely accepted as filing—the courts are willing to permit the government to ignore such rules.[150] The key factor to this willingness is the identity of the lienor; the courts view the economic value of the government's interests as sufficiently important to permit the creation of a surprise lien.

The same conclusion can be drawn with respect to mechanics' liens. As discussed above, construction liens on real property developed as an analogue to possessory liens available to mechanics and laborers who improved personal property, beginning in the late eighteenth century.[151] Although a number of different influences probably contributed to the propagation of these liens via legislation, the political clout of labor movements were likely the most significant.[152] Labor organizations and supporting political parties included construction liens as part of their platforms as a way to support the working class, creating significant and widespread political pressure that resulted in all jurisdictions adopting conforming laws within a relatively short period of time.[153]

This focus on the party entitled to the lien has not changed. Modern statutes vary as to the specific parties afforded rights,[154] but, by definition, they invariably grant rights to workers or material suppliers, and courts are quick to

[147] Nearly 175 years ago, Justice Story indicated that the reason for the rule was asserted to be that "the king is always busied for the public good, and, therefore, has not leisure to assert his right within the times limited to subjects." United States v. Hoar, 26 F. Cas. 329, 330 (C.C.D. Mass. 1821) (No. 15,373) (citing Justice Blackstone).

[148] Guaranty Trust Co. of New York v. United States, 304 U.S. 126, 132 (1938).

[149] United States v. 93 Court Corp., 350 F.2d 386, 388-89 (2d Cir. 1965) ("The policy underlying this exemption is that the failure of a government employee to bring an action within the time prescribed by a state statute of limitations should not bar the government from bringing the action if the action is one to enforce public rights or to protect the public fisc. . . . We believe the policy underlying this exemption to be generally salutary and we decline to hold that Congress must specifically endow each government corporation it creates with an expressed exemption from the bar of statutes of limitations or from the defense of laches. The Supreme Court has never ruled that there is no presumption of immunity when the United States is a plaintiff.").

[150] *See* Vohland, 675 F.2d at 1075 ("Whether or not [the estate tax lien could have been filed pursuant to § 6323], it is clear . . . that filing [thereunder] is not a prerequisite to the enforcement of a special estate tax lien against subsequent transferees.").

[151] *See supra* Part III.A.2.

[152] Nelson, *supra* note 79, at 247-48.

[153] *Id.*

[154] *See id.* at 248-49.

echo this sentiment.[155] Their interests are viewed as being uniquely at risk and so entitled to unique protection.[156]

However, that does not necessarily mean this protective motivation is without wider consideration. As with the courts' focus on the social benefit arising from a governmental right to surprise liens, the focus on the status of materialmen and laborers relates to the perception that doing so benefits society at large by incentivizing these individuals and entities to provide construction services and activities at economically feasible prices.[157]

With respect to both of the surprise liens discussed herein, a review of the judicial decisions and legislation creating and considering these encumbrances creates a perception that lawmakers focus on the status of the party claiming the lien. This fixation seems based on a view that the goals of these parties generally redound to the economic benefit of society as a whole. An increasing willingness of lawmakers to view liens from the perspective of the lienor, then, and the supposed value such liens bring to society, helps explain the emergence of surprise liens.

V. A REFUTATION OF SURPRISE LIENS

Inefficiency and disutility, two of the justifications for indifference or hostility to notice filing systems examined above, do not withstand scrutiny. These justifications are worth considering here, as they reflect considered opinion regarding lawmakers' seeming ambivalence toward property notice filing systems, but these explanations are ultimately unpersuasive as the true driver of the rising acceptance of surprise liens. Both existing academic theory and

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[155] Indeed, the purpose of mechanics' lien statutes, in general, and relation-back, specifically, is to benefit laborers and material suppliers. Judicial affirmation of the special protections afforded to this class of person or business is legion. *See* Haselwood v. Bremerton Ice Arena, Inc., 155 P.3d 952, 960 (Wash. Ct. App. 2007) (indicating that the reason for mechanics' liens is to "prevent[ ] detriment to laborers and material suppliers" and that the legislature enacted the relation-back scheme in order to "safeguard the interests of suppliers and laborers"); Klein & Sons, Inc. v. Laudeman, 311 A.2d 780, 785-86 (Md. 1973) ("[F]or a court to conclude that the resumption of work after a delay is a new project so as to prevent the relation back of a lien for work and material subsequently supplied, it must bear in mind that the purpose of the mechanics' lien law is to protect the materialmen and that this law is to be construed in the most liberal and comprehensive manner in their favor."); S. Surety Co. v. Chambers, 154 N.E. 786, 788 (Ohio 1926) ("[S]tatutes had been adopted in a number of states for the purpose of giving special protection to materialmen and laborers engaged in construction upon public buildings and public works, similar to that given them for work on private buildings under the mechanic's lien law."); Richards v. Harman, 617 S.E.2d 556, 561 (W.Va. 2005) ("It is clear that in enacting the mechanics' lien statutes . . . the Legislature sought to protect any person who increases the value of another person's real property by furnishing labor or materials.").

[156] *See* Haselwood, 155 P.3d at 960 ("Relation-back statutes are necessary to protect builders' interests because a builder or supplier cannot record a lien to protect its interests until the bill goes unpaid."). This begs the question, however, as to who, in the universe of potential creditors, is not similarly handicapped, and why it is that this particular class of creditor receives such legal aid and comfort. *See infra* Section V.

[157] *See* Nelson, *supra* note 79, at 248. Providing protected security was of particular concern during the time when many lien laws were initially passed and when liquidity and credit were far less available than today. *See id.* (citing FARNAM, *supra* note 79, at 153, 178).

some lessons from the recent financial crisis persuasively counter these arguments, so this refutation leaves lienor status, and the economic significance attached to that status, as the outstanding reason underlying the emerging trend identified and discussed herein.

A normative examination of the lienor-status bias, however, persuasively counters it as a sufficient justification for surprise liens. Allowing certain classes of lienors the right to surprise liens ultimately imposes high individual and social costs and runs counter to basic conceptions of fairness and social theory, and such liens should not be tolerated.

A. *Inefficiency & Disuse Refuted*

The economic justifications set forth above amount to an argument that certain individuals do not have sufficient economic incentive to rely on notice filing systems and, therefore, they do not rely on such systems. This lack of reliance, in turn, suggests that judicial and legislative authorities need not be overly concerned with the clear and efficient functioning of these systems and so permit, or even encourage, the existence of surprise liens. The perception that creditors do not rely on notice filing systems is based primarily upon the M-M Theorem's supposition that a company's capital structure is divorced from its value because an already leveraged firm will have to pay proportionately higher rates of return to new creditors, thus incentivizing debtors to accurately communicate their existing leverage, including security interests granted in their property. This argument, however, is not without criticism.

In particular, the supposed detachment of capital structure from value posited by the M-M Theorem seems not to accurately reflect the manner in which markets actually function.[158] Of relevance here, the M-M Theorem assumes a perfect capital market, wherein there are no taxes or transaction costs and all information is free and simultaneously available to all market participants.[159] This state clearly does not exist, so the M-M Theorem adapts itself to the existence of corporate taxes by supposing that, in a market wherein interest payments are deductible, the value of a firm's true, post-tax value should increase as its leverage does, because that type of capital is economically incentivized through lower taxes.[160] However, this necessary corollary to the M-M Theorem is at odds with reality: leverage rates in the open market vary over a wide range and generally do not approach the maximum suggested by the M-M Theorem.[161]

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[158] *See generally* M.J. Gordon, *Corporate Finance Under the MM Theorems*, FIN. MGMT., Summer 1989, at 19.

[159] *See id.*

[160] *See id.*

[161] *See generally* Merton H. Miller, *Debt and Taxes*, 32 J. FIN. 261 (1977). There are numerous potential explanations for this. For example, one explanation is to discount the assumption that investors are indifferent as between corporate and personal leverage. *See* Gordon, *supra* note 158, at 24-26. Another is that the incentive of management and other insiders to maximize net worth is not perfectly consistent with the incentive of outside investors to do the same and instead emphasizes long-term stability at the expense of appropriately weighing and incurring current risks, which results in lower than theoretically defensible leverage ratios. *See* Myron J. Gordon, *Growth and Survival in a Capitalist System*, 2 J. POST KEYNESIAN ECON. 433 (1980).

That such a state exists means that the market is not perfectly responsive to capital structure.[162] The interest rate paid by creditors on debt does not rise in direct relationship to the leverage of the firm, so debtors are not perfectly incentivized to provide accurate information to potential creditors.[163] As such, a reliable notice system (such as a real property recording system) is required to accurately convey this information.

This need, and its implicit contradiction of the non-reliance suggested by the M-M Theorem, is further reinforced by events associated with the recent economic and financial crisis.[164] The crisis is often perceived to have been triggered by a liquidity shortfall experienced by financial institutions, and to have caused the collapse of numerous financial institutions, significant downturns in stock markets throughout the world, and a "credit crunch."[165] It is considered by many to be the worst economic crisis since the Great Depression and has often been referred to as the "Great Recession."[166] These difficulties were instigated by a precipitous drop in U.S. housing prices, which had been packaged into mortgage-backed securities and sold to investors at prices based largely on reliance on the ratings and judgments of credit-reporting agencies.[167] It is the nature of the housing stock underlying these mortgage backed securities and the role of the ratings assigned to these securities by credit rating agencies (and the deference given the same by investors) that are relevant to our analysis here.

There seems to be little disagreement that the United States experienced a significant housing bubble between 2000 and 2005. Homeownership rose from 67.5 percent of U.S. households in the fourth quarter of 2000 to 69.2 percent in the fourth quarter of 2004,[168] and home prices increased by 124 percent between 1997 and 2006.[169] More people were buying more homes, and those homes were appreciating at great velocity. This was particularly pronounced in certain states, such as California, Florida, Arizona, and Nevada, where home prices more than doubled between 2000 and 2006.[170] Simply put, U.S. home

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[162] *See* Michael Bradley, Gregg A. Jarrell & E. Han Kim, *On the Existence of an Optimal Capital Structure: Theory and Evidence*, 39 J. FIN. 857 (1984).

[163] *See* Lipson, *supra* note 9, at 476-77.

[164] The "recent economic and financial crisis" refers to the financial crisis the effects of which began to be felt in 2007 and continue through the date of this Article.

[165] *See* RICHARD A. POSNER, A FAILURE OF CAPITALISM, 13-14 (2009).

[166] *See, e.g.*, Kathleen E. Keest, *Consumer Financial Services Law and Policy: 1968-20?? In the Thick of the Battlefield for America's Economic Soul*, 26 GA. ST. U. L. REV. 1087, 1090 (2010).

[167] *See* POSNER, *supra* note 165, at 18-29.

[168] ROBERT R. CALLIS & LINDA B. CAVANAUGH, U.S. DEPT. COMMERCE, CENSUS BUREAU REPORTS ON RESIDENTIAL VACANCIES AND HOMEOWNERSHIP 4 (2007), *available at* http://www.census.gov/hhes/www/housing/hvs/qtr307/q307press.pdf.

[169] *CSI: Credit Crunch*, ECONOMIST, Oct. 20, 2007, at 4, *available at* http://www.economist.com/node/9972489?story_id=9972489.

[170] Henry M. Paulson, Jr., Sec'y, U.S. Dep't of the Treasury, Remarks on U.S. Housing Market before FDIC's Forum on Mortgage Lending to Low and Moderate Income Households (July 8, 2008), *available at* http://www.ustreas.gov/press/releases/hp1070.htm. *See also* Michael Lewis, *The End*, PORTFOLIO.COM (Nov. 11, 2008), http://www.portfolio.com/news-markets/national-news/portfolio/2008/11/11/The-End-of-Wall-Streets-Boom/index2.html (indicating that, while the historical ratio of median home price to income is 3:1, by late 2004, that ratio had risen to 4:1 nationally and 10:1 in Los Angeles and 8.5:1 in Miami).

prices in the first half of the 2000s were overvalued at an untenable and historical level,[171] and a significant proximate cause of this economically unjustifiable expansion of pricing was the behavior of secured lenders.[172]

Traditionally, long-term lending secured by real estate was a low-risk banking activity. This was because, if the debtor defaulted, the creditor could seize the real estate, sell it, and recover its debt.[173] If the value of the real estate fell, the creditor might not be able to collect an amount equal to its loan, but this risk was generally minimized by only lending a relatively safe percentage of the purchase price of the real estate and only lending to creditworthy debtors.[174] For a variety of reasons, however, institutional lenders, such as banks, became very willing in the early 2000s to engage in "subprime lending."[175] This is essentially high-risk lending and involves lending more money to more people with respect to more properties.[176]

Indeed, throughout this period of time, lenders seemed intent on inventing methods of lending to previously unworthy debtors.[177] They lent to debtors with bad credit and no proof of income, and created adjustable-rate mortgages designed to defer interest payments for as long as possible.[178] So it was that secured lenders—those bastions of economic sanity whose stalwart demand for justifiable compensation based upon conservative views of risk and reward—

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171 ROBERT J. SHILLER, IRRATIONAL EXUBERANCE 14 (Broadway Books 2d ed. 2005) (2000) (likening housing appreciation to a "rocket taking off" and indicating that only the post-World War II boom can compare with the rate of home appreciation witnessed between 1997 and 2004).

172 Though there is, of course, a substantial amount of blame to go around with respect to the housing bubble and the accompanying crisis. *See* POSNER, *supra* note 165, at 1-40.

173 *Id.* at 20.

174 *Id.*

175 *See id.* at 21-25. The causes of bank behavior during this period have been subject of much speculation, including that by Judge Posner, who suggests that part of the cause is due to regulatory changes that effectively altered the financing landscape and so encouraged these practices. Others posit that governmental policies artificially inflating the incentive of banks to lend to certain groups also contributed to this state of affairs. *See, e.g.*, Carol D. Leonnig, *How HUD Mortgage Policy Fed the Crisis*, WASH. POST, June 10, 2008, at A1. Still others believe that all investors are subject to psychological pressures that lead to over-investment (in tulips, stocks, or mortgage backed securities) and the inevitably consequent bubble and crash cycle. These theories and hypotheses focus on banks, but are effectively determinative as to the entire lending community as banks create the environment in which all lenders exist. The true cause, or true combination of causes, of this behavior by lenders is outside the scope of this Article.

176 *See* POSNER, *supra* note 165, at 21-29.

177 In 2000, there was $130 billion in subprime lending with $55 billion securitized as mortgage bonds. By 2005, there was $625 billion in subprime lending with $507 billion securitized as mortgage bonds. Lewis, *supra* note 170. By 2006, as much as 40 percent of the $3 trillion mortgage market may have been to subprime or other high risk borrowers. POSNER, *supra* note 165, at 25.

178 *See* Lewis, *supra* note 170 ("In Bakersfield, California, a Mexican strawberry picker with an income of $14,000 and no English was lent every penny he needed to buy a house for $720,000."). Some of these loans were even called "NINJA loans"—No Income, No Job, No Assets. Others were based on the debtor's claim as to its income or assets. These "stated income" loans were euphemistically referred to as "liar's loans," bringing to mind Modigliani's belief that all creditors would assume that all debtors are liars, though with very different consequences than he had forecast.

abandoned any semblance of cost-benefit analysis and essentially competed for the chance to advance funds to risky debtors in a seemingly indefensible race to the bottom. This lending environment metastasized until 2007, at which point the current crisis began to reveal itself.[179]

This is not, of course, what one would expect based upon the M-M Theorem. Under this worldview, one expects creditors to so carefully scrutinize potential debtors that they collectively incentivize debtors to provide full, fair, and accurate information regarding their assets in a market-based, and hence economically efficient, manner.[180] That clearly did not occur. Instead, lenders required very little information and put very little pressure on debtors. Indeed, in a seemingly inverse perversion of the M-M Theorem, exactly the opposite pressures came to bear; rather than debtors being pressured by an acute need to satisfy lenders in order to raise capital, creditors seemed to be pressured to lend money to debtors under riskier and riskier conditions. There was, then, no real pressure on debtors to create an efficient notice system, as creditors accepted less and less, and worse and worse, due diligence.

Whatever the cause for this conflagration of theoretical incentives, at least one conclusion seems unavoidable: creditors and purchasers do require a notice system to gather verifiable information, and creditors cannot be relied on (at least in the present market and regulatory environment) to pressure debtors to provide accurate information of their own accord. As such, in the absence of an objective and independently administered system, lenders and purchasers may well abandon all caution and forego the type of meaningful due diligence that protects the market.

Additionally, there is reason to believe that creditors will rely on such an objective and independent system when it is available. In contravention of the second potential explanation for the law's acceptance of surprise liens—that creditors do not use notice systems even when they are available—we can again turn to recent events.

The purchasers of the mortgage-backed securities referenced above (the ultimate creditors) relied on credit-rating agencies to tell them the quality of their investments.[181] These securities are complicated things, aggregating hundreds or thousands of individual mortgages, and then separated into different tranches that dictate the order of repayment (i.e., investors in the first tranche get repaid first).[182] Theoretically, credit-reporting agencies would assign the first tranche a higher rating (with the highest rating being a risk-free triple-A rating) indicating a very high degree of safety because it was believed that there

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[179] *See* POSNER, *supra* note 165, at viii.

[180] As discussed above, the M-M Theorem should apply to potential buyers, as well. *See supra* notes 111-12 and accompanying text. This is particularly so where the creditor is a secured lender with respect to real estate, as the primary remedy available to such a lender is the ability to foreclose upon the real estate securing the loan. In effect, then, these creditors are effectively entering into a potential purchase transaction, where their analysis of the quality of the debtor's assets should encompass both the debtor's future prospects and the potential utility of owning the real estate at issue.

[181] *See* Felix Salmon, *The Secret Formula That Destroyed Wall Street*, WIRED MAGAZINE, March 2009, at 74, 77-79, *available at* http://www.wired.com/techbiz/it/magazine/17-03/wp_quant?currentPage=all.

[182] *See id.* at 77.

was no way that all of the relevant homeowners would default on their loans at the same time (which is effectively what would be required for the owners of the first tranche to lose their investment).[183] Subsequent tranches, or securities constituted from poor loans, would receive lower ratings and deliver a higher return due to their increased risk.[184]

These credit ratings served the same function that title searches in county records or UCC filing reports mean to serve—providing potential creditors with accurate information about the current state and future prospects of a potential debtor or the economic attributes of a seller.[185] Indeed, these ratings are the M-M Theorem in play—the manifestation of a debtor's need to provide a creditor or buyer with the type of information the creditor or buyer needs in order to provide the credit or consummate the purchase desired. Unfortunately, these market-based notices proved manifestly insufficient.[186] More troubling here, though, is that creditors arguably had sufficient reason to know that these were insufficient, even as they were relying on them.[187] There was widespread distrust and significant criticism of these ratings throughout the entire period under consideration, but that did not stop the credit market from expanding until the underlying mortgages began to default at unexpectedly high rates.[188] In other words, creditors did look for notice, but they ultimately relied on a system that was overtly inadequate.

This review of the information sought and gathered by secured real property creditors reinforces the view that credible notice systems are necessary to an efficiently functioning lending and purchasing environment. Without them,

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[183] *See id.*

[184] *See id.*

[185] *See id.*

[186] *See id.* at 77-79. As discussed therein, part of the difficulty in assigning a triple-A rating to a mortgage backed security was that while it was generally unlikely that a whole cross-section of homeowners would suffer the kind of individual setback that would cause default (illness, job loss, etc.), there are risks (such as a decline in values, which is due to propagating, market-based influences) that do affect a large number of people at once. This concept, called correlation, means that certain types of risk reverberate throughout a pool of risk, and is important in determining the overall quality of the tranche in question. For many years, this risk was too difficult to quantify, so the ratings conservatively valued this type of investment. In 2000, however, Dr. David X. Li published a paper hypothesizing that the risk of a mortgage-backed security could be tied to the market for credit default swaps (here, a derivative tied to the market's estimate of an underlying default). Dr. Li posited a formula—the Gaussian Copula Formula—that did this in a mathematically defensible manner that provided the rating industry with a theoretical tool to assign historically positive ratings. And it did so with gusto, bundling and securitizing almost any type of obligation and turning it into a triple-A security. Indeed, the agencies often assigned triple-A ratings to tranches even if none of the component obligations were themselves of that quality. *See also* Lewis, *supra* note 170 ("Wall Street investment banks took huge piles of loans that in and of themselves might be rated BBB, threw them into a trust, carved the trust into tranches, and wound up with 60 percent of the new total being rated AAA.").

[187] *See* Salmon, *supra* note 181, at 77-79 (indicating that, even before the dissemination of ratings based on the Gaussian Copula Formula, there was significant criticism of attempts to correlate financial quantities and that, even during its use, there was a widespread belief that it was not suitable for risk valuation). *See also* Lewis, *supra* note 170 ("We always asked the same question," says Eisman. "Where are the rating agencies in all of this? And I'd always get the same reaction. It was a smirk.").

[188] *See* Salmon, *supra* note 181, at 79.

creditors will either permit debtors to engage in widespread chicanery or rely on questionable market-based provisions of information. Additionally, even if creditors and buyers are not directly relying on the notice filing systems available to them, they are likely relying on information that intermediaries who do (or should) rely on such systems have.[189] Title insurers and rating agencies might save creditors from having to directly examine security filings, but those companies themselves rely on such filings. Similarly, MERS is only useful after the mortgage has been recorded in the property-recording system because it relies upon established notice filing systems to secure the priority and integrity of the mortgage and only thereafter allows members to buy and sell among themselves.[190]

Accordingly, there is little actual validity to the theoretical idea that creditors should not require a real property filing system or that they do not rely on the current systems available to them. This refutation, and the essential economic facts underpinning it, indicates that these arguments, while theoretically interesting, are not the true drivers behind the rise of surprise liens.

B. Lienor Identity Refuted

If economic theory does not provide a reasoned basis for allowing surprise liens, lienor identity remains as the relevant justification. As set forth above, it appears that lawmakers have focused on lienor identity due to a belief that the activities or goals of these particular lienors create a wider economic and social benefit.[191] This conclusion leads to a focused line of analysis as to whether surprise liens truly accomplish their purpose of creating wider social benefit. They do not.

From an economic standpoint, status-driven surprise liens focus solely on the lienors at issue, in the circumstances at issue, and ignore the wider systemic costs inherent in such liens. From an equitability standpoint, these liens contravene established principles and mores present in our legal and social system, and so offend basic notions of ethics and fairness, particularly in light of the

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189 *See* LoPucki, *supra* note 117, at 1941.

190 *See* Phillips, *supra* note 126, at 263-64.

191 *See supra* Part IV.C. This presents an interesting contrast with priming liens. Such priming liens explicitly attach *after* the interest that is subsequently overcome. *See, e.g.*, *In re* Huber Contracting, Ltd., 347 B.R. 205, 216 (Bankr. W.D. Tex. 2006) ("[P]riming liens . . . truly arise and attach *after* another validly recorded lien such that the lien has equal or superior rights in the same collateral."). Effectively, then, such liens constitute a type of taking. *See* Richard A. Epstein, *The Next Generation of Legal Scholarship?*, 30 STAN. L. REV. 635, 640 (1978) (defining a taking of property as "[a]ny diminution of rights in the bundle of any holder, no matter what becomes of those rights"). The focus in such cases is an explicitly normative one on which a party "should" have the property given the relative equities of the parties involved and the specific benefits accruing to the "primed" party. *See generally* Robert S. Bozarth, *Environmental Liens and Title Insurance*, 23 U. RICH. L. REV. 305 (1989); Jarrod B. Martin et al., *Freefalling with a Parachute that May Not Open: Debtor-in-Possession Financing in the Wake of the Great Recession*, 63 U. MIAMI L. REV. 1205 (2009). These constitute direct and frank decisions by legislators that a primed party is appropriately deprived of its interest. Surprise liens, on the other hand, are more subtle deprivations of rights and focus on society-wide costs and benefits, as opposed to the rights of the parties directly involved.

long-standing and widely accepted nature of the information and rights imparted by real property recording acts.

1. *Economic Arguments Against Surprise Liens*

Lawmakers increasingly accept the existence and usage of surprise liens by certain types of lienors because they believe permitting such persons or entities this special right redounds to the economic benefit of society as a whole, while only negatively affecting a discrete number of ostensible title holders.[192] However, this belief is ultimately incorrect. Surprise liens undermine the informational role that determinate property rights and expectations play, creating systemic costs borne by society at large. These costs must be balanced against the economic benefits supposedly wrought by such liens.

a. *The High Cost of Hidden Property Rights*

Surprise liens undermine notice filing and the informational role it plays in society. This role is effectively a proxy one, supporting and sustaining that role served by property law as a whole.[193] Property has conservatively been defined as "that [s]ole and de[s]potic dominion which one man claims and exercises over the external things of the world, in total exclusion of the right of any other individual in the univer[s]e."[194] This conception of property rights focuses upon the in rem nature of property—rights are defined with respect to an actual, concrete thing.[195] Some have interpreted this as creating impersonal and non-specific duties, absent from flexible personal rights, that are concretely and universally "broadcast to the world from the thing itself."[196]

Thomas Merrill and Henry Smith, in particular, have elaborated upon the role and nature of property rights in effectively and efficiently conveying information to society as a whole.[197] Merrill and Smith argue that such a specific and clear set of duties attaching to "everyone else" permits people to clearly perceive rights and obligations and to economically arrange their plans.[198] However, this clear perception of rights arises because the law imposes a significant burden on essentially everyone, including third parties who presumably have no need to understand the rights and responsibilities of parties to a contractual arrangement.[199] Such a burden is possible only so long as property remains relatively simple and standardized so that "everyone else" can understand the rights flowing from it easily and with little cost. This general limita-

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[192] *See supra* Part IV.C.

[193] *See* Lipson, *supra* note 9, at 438-40.

[194] 2 WILLIAM BLACKSTONE, COMMENTARIES ON THE LAWS OF ENGLAND 2 (photo reprint, William S. Hein & Co., Inc. 1992) (1766).

[195] This traditional view of property, echoed by Adam Smith and Jeremy Bentham, may be contrasted with the more recent view of property rights as a more malleable "bundle of rights." *Compare* ADAM SMITH, LECTURES ON JURISPRUDENCE 9-86 (R.L. Meek et al. eds. 1978), *and* JEREMY BENTHAM, THE LIMITS OF JURISPRUDENCE DEFINED 164 (1945), *with* Felix S. Cohen, *Dialogue on Private Property*, 9 RUTGERS L. REV. 357, 370 (1954).

[196] Thomas W. Merrill & Henry E. Smith, *What Happened to Property in Law and Economics?*, 111 YALE L.J. 357, 359 (2001).

[197] *See generally id.*

[198] *Id.* at 359.

[199] *Id.*

tion is known as the "numerus clausus" (meaning "closed number") and posits that "[a]ll modern property systems limit the forms of ownership and standardize property along many dimensions."[200] Merrill and Smith believe that courts and scholars generally honor this conception of property despite their protestations to the contrary: "They treat previously-recognized forms of property as a closed list that can be modified only by the legislature."[201]

By honoring this concept of numerus clausus (that is, by restricting property rights to a fixed number of forms), the law effectively guards against the extraordinary informational costs that would flow from recognizing the unending number of unique property rights that parties would develop of their own accord:[202]

> Limiting the number of basic property forms allows a market participant or a potential violator to limit . . . inquiry to whether the interest does or does not have the features of the forms on the menu. Fancies not on the closed list need not be considered because they will not be enforced.[203]

This standardization lowers the cost of determining the nature of the property rights at issue and so economically benefits society as a whole.[204]

The relevance here of the conception of limited property rights and their value to society is that notice systems support this efficiency by "channel[ing] transaction forms in ways that pure contract would not."[205] Parties and their lawyers, ever mindful of the settled manner in which property interests are recognizably and reliably defined and described in notice systems, likely struc-

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200 *Id.* at 385 (citing Thomas W. Merrill & Henry E. Smith, *Optimal Standardization in the Law of Property: The Numerus Clausus Principle*, 110 YALE L.J. 1, 4 (2000)).

201 Merrill & Smith, *supra* note 200, at 10-11.

202 *See id.* at 25. Citing the case of *Keppell v. Bailey*, (1834) 39 Eng. Rep. 1042 (Ch.), Merrill and Smith call such unique property rights "fancies."

203 *Id.* at 33. "Perhaps the key point about the numerus clausus is informational: The forced standardization of property forms creates a kind of shorthand which, in turn, reduces information costs." Lipson, *supra* note 9, at 497. Put differently, different people with different rights to a single asset "need some means of assuring that they share a common understanding of those rights." Henry Hansmann & Reinier Kraakman, *Property, Contract, and Verification: The Numerus Clausus Problem and the Divisibility of Rights*, 31 J. LEGAL STUD. 373, 382 (2002). Without that understanding, there is potential for the parties to "mistakenly make inconsistent uses of the asset or underuse the asset" or to misallocate resources due to a fear that "the other will . . . opportunistically assert rights that properly belong to the other." *Id.* A failure to reach such a common understanding will result in the parties taking costly actions to protect their rights, and in a general discouragement in improving and using assets. *See id.*

204 *See* Merrill & Smith, *supra* note 200, at 33. This leads to the conclusion that there is a preferred balance as to the economically appropriate number of recognizable property forms. *See id.* at 39-40. Measurement and error costs would be lowest, for example, in a fixed system that only recognizes a single type of property interest. *See id.* "On the other hand, by grandfathering in existing forms of property, and permitting legislative creation of new forms, the *numerus clausus* permits some positive level of diversification in the recognized forms of property." *Id.* at 40.

205 Lipson, *supra* note 9, at 496. Professor Lipson identifies the nature and import of property rights in general, and the numerus clausus in particular, and indicates the supporting role that notice filing plays with respect to the same, in the context of personal property notice filing. The concept applies to real property records, and the harm done to them by surprise liens, as well. *See id.* at 496-501.

ture their transactions in conformance with settled tradition and history.[206] Surprise liens undermine this supporting role by weakening the importance and effectiveness of notice systems.[207]

"To the extent we abandon notice filing, therefore, we . . . drive up the cost of obtaining information about the types of, and interests in, property."[208] In other words, surprise liens, such as those considered herein, create an ambient cost to society as a whole by fostering uncertainty as to the nature of property rights held by others and so increase the costs generally required to discover the same.

b. A Questionable Allocation of Rights

Permitting surprise liens also functions as a questionable reallocation of the rights that the parties themselves established in the context of generally accepted notions of notice and fairness. Initially, the perceived costs incident to this ostensibly beneficial shifting of rights seems relatively small. This is because they appear to fall solely upon the surprised party, and even those costs appear largely compensable to true bona fide purchasers or purchasers with adequate title insurance. Both of these consolations, however, do not withstand scrutiny, and, upon more careful consideration, it becomes clear that sanctioning surprise liens actually creates significant individual and societal costs.

First, the perception that surprised parties have effective redress for their loss is false. Superficially, this belief may appear true because a bona fide purchaser subject to a surprise lien likely has some sort of private redress to the party from which it received the asset.[209] However, this apparent ability to be

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[206] *See id.* at 496. Professor Lipson bases his claim on personal experience and personal discussions. The author echoes this claim, based upon his own practice and that of his partners and colleagues. It is conceivable that a purchaser of real property, or a creditor securing a loan in real property, will either create a unique real property interest or describe a traditional interest in a new and unique manner, but doing so in the context of the real property recording acts creates a significant risk that others will not understand the intent of the parties to the contract, and so will not be put on notice as to the relevant party's property interest. Such a risk generally serves as adequate incentive to stay within the accepted bounds of traditional property law.

[207] This view of the numerus clausus is subject to some criticism. *See generally* Hansmann & Kraakman, *supra* note 203. Therein, the authors argue that substantive property rights are not limited, but that the manner in which rights holders put others on notice is. They agree that there is a connection between property rights and notice, but disagree as to the mode and manner in which this notice is communicated. *Id.* at 174-75.

[208] Lipson, *supra* note 9, at 496.

[209] *See, e.g.*, Holzworth v. Roth, 101 N.W.2d 393, 395 (S.D. 1960) (discussing liability of grantor to grantee with respect to claimed mechanics' lien). This is not universal, however. If the grantee took the real property by means of something less than a warranty deed—i.e., a quitclaim deed or a bargain and sale deed—then the grantee may have no claims against the grantor. Such a situation may not inspire economic solicitude, however, as it is likely that purchasers under such circumstances paid an overtly compromised price for such title, and are not, therefore, truly deprived of their "bona fide" price. Moreover, grantees may have other common law claims or claims against others further up the chain of title. *See, e.g.*, Gawron v. Robert Dev. Corp., 107 N.W.2d 878, 880 (Mich. 1961) (holding that a seller's covenant to pay all taxes and assessments that were a lien on the land at date of contract survived closing); Estate of O'Neal v. United States, 228 F. Supp. 2d 1290 (N.D. Ala. 2002) (considering a transferee claim against an estate for restitution arising from

made whole is extremely misleading because it ignores both the possibility that the prior owner lacks sufficient resources and the costs inherent in any litigation required for a surprised owner to recover from a prior owner.

As to the prior owners' resources, little can be said with certainty other than there will be some portion of cases where the prior owner does not have the resources to make the new owner whole on account of the surprise lien.[210] Whatever this portion is, it lowers the effective remuneration available to surprised owners. Moreover, even if the prior owner does have sufficient resources, reaching them likely involves the expenditure of significant resources in litigation. And litigation constitutes a significant transaction cost.[211] This further erodes the effective redress available to surprised owners and weakens the argument that the individual costs are not significant.

The argument that the cost of shifting the ownership rights is isolated to the parties affected also fails. One reason for this failure is that the litigation costs identified above also accrue to society at large.[212] The American system of justice requires public expenditures on judges, court employees, physical facilities, and all the other elements of the court system.[213] By encouraging litigation, surprise liens ultimately encourage these types of social costs. Surprise liens also cause widespread costs in that they increase the title insurance premiums paid by every party purchasing such insurance. Surprise liens, of course, affect the condition of title, so—although there is some question as to whether this coverage customarily covers surprise liens such as the ones discussed herein[214]—there is no question that title insurers pay some portion of the losses incurred due to surprise liens or, at least, pay the litigation costs

§ 6324 liability of transferee). Based upon anecdotal evidence, the author can confirm that IRS revenue agents do, in the context of a § 6324 surprise lien, view the potential claims of a surprised owner as a type of "just compensation" that largely removes the burden of the tax lien.

210 Based upon the author's personal experience, this is not a small portion of the time. Prior owners often utilize a significant portion, or all, of the proceeds arising from sales to pay off secured loans on the property sold, which proceeds are not theoretically reachable by the new owner. Additionally, in the commercial context, many sellers are corporate or business entities, which often immediately, and irrevocably, disburse the proceeds of sale upon closing.

211 *See, e.g.*, E. Donald Elliott, *Managerial Judging and the Evolution of Procedure*, 53 U. CHI. L. REV. 306, 330-33 (1986) (identifying and discussing three types of transaction costs associated with litigation: (1) agency costs, (2) litigation costs, and (3) costs to society); Robert M. Ackerman, *Tort Law and Communitarianism: Where Rights Meet Responsibilities*, 30 WAKE FOREST L. REV. 649, 687-88 (1995) (discussing the burden on the community imposed by tort and commercial litigation).

212 *See* Ackerman, *supra* note 211, at 688.

213 *Id.*

214 *See supra* note 73.

associated with defending against them.[215] These costs are necessarily passed through to all consumers of title insurance, in the form of higher premiums.[216]

Thus, surprise liens do, in fact, create significant costs that are born both by the surprised owner and by society in general. There is no reason to believe the supposed benefits such liens create outweigh these costs, so lawmakers' willingness to reallocate property rights in the face of general expectations is a questionable one.

2. *The Equitable and Ethical Argument Against Surprise Liens*

Even if the economic benefits engendered by permitting certain lienors the ability to use surprise liens do outweigh the costs created by surprise liens (a proposition that is not by any means clear),[217] one must still consider the equitable and ethical issues inherent in permitting surprise lienors to trump the interests of bona fide title holders.

From an equitable perspective, the law has consistently found such liens to be unfair. Surprise liens defeat the legitimate expectations of bona fide purchasers[218] and so create significant uncertainty.[219] There is a deep resentment of the costs caused by this uncertainty, and such liens have often been viewed as little more than outright fraud.[220] This belief arises from basic conceptions of fairness and due process. Constitutional due process is meant to protect against arbitrary deprivations of property,[221] and sanctioning and enforcing liens absent public notification *seems* to conflict with justified expectations and to generally deprive people of their legitimate property rights, whether arising

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[215] *See* Murray, *supra* note 4, at 59 (noting that the duty to defend is broader than the duty to indemnify and is invoked if a claim "is arguably covered by the insuring provisions of the policy."); *see, e.g.*, Chic. Title Ins. Co. v. Fed. Deposit Ins. Corp., 172 F.3d 601 (8th Cir. 1999) (involving a title insurance company indemnifying an owner against mechanics' liens); First Am. Title Ins. Co. v. United States, No. 04-429, slip op. at 1-2 (W.D. Wash. May 12, 2005) (involving a title insurance company indemnifying an owner against a § 6324 lien).

[216] Title insurance is unlike other types of insurance in that it does not underwrite on a risk assumption basis. *See* Robert S. Bozarth, *Commercial Mortgage Finance: Title Insurance Issues and Endorsements—Multi Site Issues*, *in* TITLE INSURANCE 2005: MASTERING CRITICAL ISSUES FACING BUYERS, SELLERS & LENDERS 291, 294 (Practising Law Institute ed., 2005). In other words, the insurer is not guided by actuarial tables or mathematical computations of loss expectancy. Instead, it relies on title research to eliminate extant risk. *See id.* Nevertheless, title insurance companies are required to reserve for loss and must include their expected losses in the cost of their policies. *See* Janet A. Alpert, *Trends and Transformations in the Title Industry*, *in* TITLE INSURANCE 1996: THE BASICS AND BEYOND 377, 383 (Practising Law Institute ed., 1996).

[217] There is no indication that any empirical or even focused study or analysis has been attempted or completed along these lines.

[218] *See supra* note 12.

[219] *See* Jeffrey Davis, *Fixing Florida Execution Lien Law*, 48 FLA. L. REV. 657, 657-58 (1996); *see also In re* Badger Lines, Inc., 199 B.R. 934, 939 (Bankr. E.D. Wis. 1996) ("Secret liens can only produce uncertainty for potential, unsuspecting creditors . . . .").

[220] *See* Richard L. Barnes, *Reaffirming the Dominance of Notice in Article 9: A Proposed Modification of Priorities in Returned and Repossessed Goods*, 48 U. PITT. L. REV. 353, 385 (1987)

[221] Michele L. Jacobson, *Rico Post-Indictment Restraining Orders: The Process Due Defendants*, 60 N.Y.U. L. REV. 1162, 1165 (1985).

from a governmental surprise lien or from state-sanctioned enforcement of a private surprise lien.

As explained above, the courts have generally eschewed this approach by finding surprise liens to be explicitly constitutional.[222] However, this view is not monolithic.[223] Indeed, constitutional due process is implicated in connection with a plethora of rights,[224] so it is not unreasonable that many view the basic contours of this right as at least tangentially connected with the idea that surprise liens act as an effective deprivation of property without notice. Regardless of the precise connection, there is a general and legitimate expectation in our system of governance and jurisprudence that property rights are entitled to the well-known benefits of adequate notice and fair hearing.[225] This expectation, and the rights underlying it, convincingly argues against permitting surprise liens absent a strong countervailing interest.

Moreover, from an ethical perspective, there is a strong argument that society should discourage surprise liens. These liens are, by definition, secret because they prevent a clear and accurate appraisal of the value of property. This seems problematic, and this conclusion is both intuitively appealing and credible. It is credible because it derives from a concrete analysis of social ethics theory focusing on utilitarianism and the work of John Rawls and John Harsanyi.[226]

Initially, the overt appeal of accuracy may appear to arise from the theory of utilitarianism. Under this theory, society should focus on maximizing social utility.[227] This involves preventing people from purchasing the "wrong" property, because misguided purchases undermine both individual and societal utility.[228] As such, accurate information, and the accurate pricing that flows from

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[222] *See supra* note 71, discussing *Sessler v. United States*, 7 F.3d 1449 (9th Cir. 1993). *See also* Laurel E. Lockett, *Environmental Liability Enforcement and the Bankruptcy Act of 1978: A Study of H.R. 2767, the 'Superlien' Provision*, 19 REAL PROP. PROB. & TR. J. 859, 882 (1984) (acknowledging that secret liens appear to violate due process requirements but concluding that they "have been found constitutionally acceptable.").

[223] *See, e.g.*, Lanterman v. Luby, 114 A. 325, 327 (N.J. 1921) (holding that if the statute there at issue had "expressly included subsequent innocent purchasers for value without notice within those against whom the right of seizure . . . would exist . . . the act would be unconstitutional as a deprivation of property without due process of law.").

[224] *See* Goldberg v. Kelly, 397 U.S. 254, 262 (1970) (indicating that due process rights may be implicated in connection with the adjudication of such "important rights" as "withdrawal of public assistance benefits," "disqualification for unemployment compensation," "denial of a tax exemption," and "discharge from public employment.").

[225] JOHN E. NOWAK & RONALD D. ROTUNDA, CONSTITUTIONAL LAW 694 (8th ed. 2010).

[226] *See generally* Jeff Schwartz, *Fairness, Utility, and Market Risk*, OR. L. REV. (forthcoming) [hereinafter Schwartz, *Fairness*], *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1565834 (examining the works of Rawls and Harsanyi in the context of securities regulation).

[227] *See, e.g.*, Lawrence Zelenak, *Tax Policy and Personal Identity Over Time*, 62 TAX L. REV. 333, 370 (2009).

[228] *See* Schwartz, *Fairness*, *supra* note 226 (manuscript at 10). The negative effects on the individual are clear. The negative effects on society are just as pronounced. If purchasers select overpriced or the wrong type of property, appropriately selective market competition is compromised, and resources will be incorrectly allocated. *See id.* If this occurs, "good" developments or investments will be overvalued, and "bad" developments or investments will be undervalued.

it, appears to serve utilitarian goals. This conclusion, however, is oversimplified. Utilitarianism itself does not sufficiently support the intuitive ideal that surprise liens are pernicious.

The decision to purchase a piece of real property broadly consists of two decisions: (1) how much to pay, and (2) what type of property to purchase.[229] Complete and accurate information regarding potential and actual liens aids in the first decision but not necessarily in the latter. Accordingly, the price could be accurate, but purchasers still might purchase the wrong *type* of property.[230] It seems logical that, even if the purchase is not perfect, complete information should at least make the price more accurate, but this is not necessarily the case. Although correct pricing is generally an important factor as to whether individual utility is maximized, that is not unavoidably so where one buys primarily for investment purposes.[231] In such a situation, the purchaser's utility is measured solely by whether the value of the property purchased rises, not whether the initial price was accurate.[232] Additionally, it is not really clear that society has much of an interest in whether buyers and sellers of real property receive the "right" price. Purchasing and selling real property primarily acts as a transfer of resources among the parties to the transaction in which society neither suffers nor benefits.[233] That is, if a buyer pays too much, a seller receives that overpayment as excess, so the imbalance has a zero net effect on society as a whole. Accordingly, whether real property prices are "right" should have no real effect on social well-being.

However, finding a defensible justification for the law's abhorrence of surprise liens is important, because a failure to do so could call into question a seemingly basic element of real property law. In order to do so, we must go beyond a basic analysis of utilitarianism. The works of John Rawls and John Harsanyi do just that.

The Rawlsian view of justice and social obligation is based largely on the earlier work of Thomas Hobbes, Jean-Jacques Rousseau, Immanuel Kant, and John Locke.[234] Rawls contrasted the real world in which our norms and ethics evolved with that of a clean social slate—or an "original position"—in which the founding members of society could originally and fairly establish a com-

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[229] *See id.*

[230] Whether purchased for personal or investment purposes, the purchase of real property is likely a significant financial transaction to the purchaser. Likewise, regardless of the precise purpose of the transaction, it will only serve the intent of the purchaser if it is the right class of property.

[231] *See* Schwartz, *Fairness*, *supra* note 226 (manuscript at 11) (citing Lynn A. Stout, *The Unimportance of Being Efficient: An Economic Analysis of Stock Market Pricing and Securities Regulation*, 87 MICH. L. REV. 613, 700 (1989)).

[232] *See id.* Purchasing real estate for investment purposes has assumed a heightened importance in modern commerce, and buying property merely "to live in" has come to be an increasingly quaint pursuit. And when one purchases for investment purposes, one is merely concerned with profit, which depends on appreciation, and which makes realty seem very much like a security. *See, e.g.*, RICHARD A. BREALY, ET AL., PRINCIPLES OF CORPORATE FINANCE 192-99 (10th ed. 2011) (describing the "Capital Asset Pricing Model" for securities, which focuses on return and risk).

[233] *See* Schwartz, *Fairness*, *supra* note 226 (manuscript at 12 & n.64).

[234] *See* Samuel Freeman, *Introduction* to THE CAMBRIDGE COMPANION TO RAWLS 1, 10 (Samuel Freeman ed., 2003).

plete slate of laws and social institutions.[235] In an original position, founders would create a society from a position of ignorance wherein they would not know whether their interests in the new social order would be ones of privilege or poverty.[236] Rawls concluded that this ignorance would cause these individuals to establish a system that equally distributes good fortune among all members of the community.[237] Such a system, focusing on equality and reciprocity, would incorporate the "difference principle," which is "an agreement to regard the distribution of native endowments as a common asset and to share the benefits of this distribution whatever it turns out to be."[238] Thus, arbitrarily allotted endowments, such as good fortune, inherent talent, or native intelligence, would be shared with the less fortunate.[239]

This difference principle provides a moral and ethical justification for helping the poor, but it also provides the same justifications for risk management on a societal scale. According to Rawls, if individuals recognize that good or bad fortune is the result of pure chance, they will create a society wherein the randomness of fortune is shared equally by all.[240] This concept of sharing and spreading random risk suggests that government should help individuals manage volatility because volatility is a random manifestation of fortune and so a significant cause of risk.

This concept of risk-and-reward distribution and risk management dovetails nicely with the ethical philosophy posited by John Harsanyi.[241] Professor Harsanyi began his analysis similarly to Rawls, by conceiving individuals building a society from nothing.[242] These founders must design a society in which they will participate, but they do not know whether they will benefit or suffer from the flights of fortune.[243] Here, Harsanyi and Rawls part company. Harsanyi posits that such individuals (rather than accepting and embracing reciprocity) would seek to create systems and structures that maximize expected utility.[244] In truth, however, this position, and its logical result, is quite close to that of Rawls. Harsanyi's founders, in attempting to maximize utility from their state of ignorance, must rationally plan for the possibility that they might begin from a personal position of good fortune or bad fortune.[245] Doing so would necessarily prod them to create a society that would protect them from risk if they began on the bottom rung of society.[246]

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235 *See* JOHN RAWLS, A THEORY OF JUSTICE 225 (Erin Kelly ed., 1971).
236 *See id.* at 118-123.
237 *See id.*
238 *See* Schwartz, *Fairness*, *supra* note 226 (manuscript at 13) (quoting JOHN RAWLS, JUSTICE AS FAIRNESS: A RESTATEMENT 75 (2001)).
239 *See id.*
240 *See id.*
241 This juxtaposition is telling, given that Rawls ostensibly developed his difference principal and resultant view of risk sharing in response to utilitarianism, which he viewed as insufficient. *See* Schwartz, *Fairness*, *supra* note 226 (manuscript at 16) (relying on SERGE-CHISTOPHE KOLM, MODERN THEORIES OF JUSTICE 169 (1996)).
242 *See* John C. Harsanyi, *Can the Maximin Principle Serve as a Basis for Morality? A Critique of John Rawls's Theory*, 69 AMER. POL. SCI. REV. 594, 598 (1975).
243 *See id.*
244 *See id.*
245 *See id.* at 598-600.
246 *See id.*

Both Rawls and Harsanyi agree that society should manage risk by reducing volatility and risk as much as possible.[247] One of the primary ways in which society can do this is by fostering accurate information.[248] Surprise liens are, by definition, secret, and therefore antithetical to accuracy. Accordingly, preventing secret liens serves the goal of risk management and is a legitimate and important social goal stemming from Rawls's and Harsanyi's views of social justice.[249]

VI. Conclusion

Surprise liens have a long and storied history, and much real property and commercial law has been fashioned to prevent them and avoid their consequences. Real property recording acts, and the notice filing system accompanying them, significantly reduced the presence and significance of these liens, and have created a widespread belief among attorneys and lay people that surprise liens either no longer exist or pose no true danger to bona fide purchasers. This belief is not accurate, however, because surprise liens have never entirely gone away and lawmakers are increasingly willing to make surprise liens available to certain classes of lienors.

This increasing willingness, as demonstrated by the recent emergence of the estate tax lien and mechanics' liens that relate back, is potentially explicable due to theoretical criticisms of the efficiency and utility of real property notice systems. These arguments, however, do not withstand existing criticism or review in light of recent economic events. The elimination of these justifications and the nature of, and circumstances associated with, surprise liens indicate that the true reason underlying the recent trend toward accepting surprise liens is a belief by lawmakers that certain classes of lienors should be afforded special consideration because doing so benefits society at large.

However, such reasoning is insufficient to support the existence of suprise liens for numerous reasons. First, there is reason to think the belief that society benefits from such liens is false. Although some benefit may accrue to society, such liens also cause significant costs to society in the forms of increased information costs, litigation related externalities, and increased title insurance premiums. Second, the individual costs of surprise liens are likely higher than believed. Finally, surprise liens strike at basic and deeply held conceptions of ethics and fairness inherent in our system of property rights and should not be permitted lightly.

Accordingly, lawmakers should eschew the temptation to permit privileged classes of lienors the right to surprise liens. This can be done easily by eliminating statutory and judicial exceptions to the existing real property recording acts, which require all parties to put the public on notice of their claimed interests. Doing so simply and effectively avoids the economic and

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[247] Rawls and Harsanyi have both acknowledged the similar conclusions fostered by their philosophies. *See* Schwartz, *Fairness*, *supra* note 226 (manuscript at 17 n.96 and accompanying text).

[248] *See* Schwartz, *Fairness*, *supra* note 226 (manuscript at 18) (citing George J. Stigler, *The Economics of Information*, 59 J. Pol. Econ. 213, 214 (1961)).

[249] *See id.* (manuscript at 13-19).

equitable costs discussed above, comports with basic American conceptions of fairness, and is consistent with the basic beliefs and expectations of society at large.