

# Commonwealth of Kentucky

## Court of Appeals

NO. 2007-CA-000009-MR

COMMONWEALTH OF KENTUCKY,  
FINANCE & ADMINISTRATION CABINET,  
DEPARTMENT OF REVENUE,  
f/k/a REVENUE CABINET

APPELLANT

v. APPEAL FROM JEFFERSON CIRCUIT COURT  
HONORABLE LISABETH HUGHES ABRAMSON , JUDGE  
ACTION NO. 06-CI-000331

CENTRAL BANK OF JEFFERSON COUNTY, INC.,  
f/k/a FIRST BANK, INC.; SHANNON FOSTER, a/k/a  
SHANNON E. MCDONALD FOSTER; STEVE J. FOSTER;  
HOLLOWAY & SON CONSTRUCTION, LLC;  
DEBRA B. COPELAND; and HAGAN AUTOMOTIVE TIRE,  
a/k/a HAGAN AUTOMOTIVE & TIRE, INC.

APPELLEES

NO. 2007-CA-000833-MR

COMMONWEALTH OF KENTUCKY,  
FINANCE & ADMINISTRATION CABINET,  
DEPARTMENT OF REVENUE,  
f/k/a REVENUE CABINET

APPELLANT

v. APPEAL FROM BULLITT CIRCUIT COURT  
HONORABLE RODNEY BURRESS, JUDGE  
ACTION NO. 04-CI-01100

WELLS FARGO BANK, MINNESOTA, N.A.;  
JOSEPH A. CLARK; JANET M. CLARK, a/k/a JAN  
CLARK; GE CAPITAL FINANCIAL, INC.; UNITED  
STATES OF AMERICA; ARTHUR SULLIVAN; and  
STANDARD FEDERAL SAVINGS BANK

APPELLEES

OPINION  
REVERSING AND REMANDING

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BEFORE: DIXON AND NICKELL, JUDGES; KNOPF,<sup>1</sup> SENIOR JUDGE.

KNOPF, SENIOR JUDGE: In each of the two present appeals, the Commonwealth of Kentucky, Department of Revenue (“DOR”) seeks to be given priority as lien holder before a mortgage. Our resolution of the issue presented requires us to determine the following issues: 1) does a tax lien lose its priority when another lien takes an earlier filing date through the process of equitable subrogation; and 2) do purchase money mortgages take preference over a prior-recorded general tax lien.

Although the issues in these two cases are distinct, they each pertain to the special preference, if any, granted to tax liens, and therefore will be addressed together.

**I. BACKGROUND**

**COMMONWEALTH v. CENTRAL BANK, ET AL.**

On July 11, 2001, the DOR filed a general state tax lien against Steve J. Foster in the Jefferson County Clerk’s office. On July 26, 2001, Steve and Shannon Foster executed a promissory note (note I), secured by a mortgage on real property in favor of Central Bank of Jefferson County, Inc. (“Central”). The mortgage was recorded in the Jefferson County Clerk’s office on August 17, 2001. The Fosters also executed a note evidencing a line of credit (note II) by Central. Note II was secured by a mortgage on the property recorded on August 17, 2001. The Fosters used a portion of note I to satisfy a mortgage on the real property held by Commonwealth Bank & Trust Company<sup>2</sup>

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<sup>1</sup> Senior Judge William L. Knopf sitting as Special Judge by assignment of the Chief Justice pursuant to Section 110(5)(b) of the Kentucky Constitution and Kentucky Revised Statutes 21.580.

<sup>2</sup> CBT’s mortgage was recorded on August 17, 1998, in the Jefferson County Clerk’s office. It was released by a Deed of Release recorded on August 20, 2001.

("CBT") and the remainder of the note to pay off ad valorem taxes.<sup>3</sup> On September 6, 2001, the DOR filed a general state tax lien against Shannon.

On January 12, 2006, Central initiated a foreclosure action in circuit court against real property owned by Steve and Shannon. Central moved for summary judgment, asserting that its mortgage should be awarded first priority over the other liens on the property.<sup>4</sup> Central argued that because the proceeds from note I were used to satisfy CBT's mortgage and the ad valorem taxes, that its mortgage for note I should be equitably subrogated to those liens. On June 13, 2006, a hearing was held before the master commissioner ("MC"). On June 19, 2006, the MC issued a report, setting forth his recommendations and finding that Central's first mortgage, on note I, was equitably subrogated to CBT's mortgage and the ad valorem tax liens to the extent that the proceeds from note I were used to satisfy such.

The DOR filed exceptions to the MC's report, claiming that equitable subrogation is not the law in Kentucky and asserting a super priority pursuant to KRS<sup>5</sup> 134.420. Central also filed exceptions, pointing out that the MC had failed to address certain issues in his report. On August 15, 2006, the MC conducted a second hearing and on August 28, 2006, issued a new report, recommending that the exceptions of the DOR be denied. On November 30, 2006, the Jefferson Circuit Court entered a judgment and an order of sale, directing the proceeds from the sale to be distributed in the following priority: 1) to the costs of the action; 2) to satisfy that portion of Central's lien on note I, accounted for as equitable subrogation, until paid; 3) to satisfy that

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<sup>3</sup> Three liens for ad valorem taxes were recorded, on a certain date unknown, but prior to the CBT mortgage lien.

<sup>4</sup> Several other liens, from: Holloway & Son Construction, LLC; Debra B. Copeland; and Hagan Automotive Tire, were placed on the property but were released on January 24, 2006, January 17, 2006 and January 12, 2006, respectively.

<sup>5</sup> Kentucky Revised Statutes.

portion of Central's lien on note II, accounted for as equitable subrogation, until paid; 4) to satisfy the balance of Central's liens, as adjudicated and the DOR's liens, as adjudicated, equally; and 5) any remaining proceeds to be held for the remaining defendants as their interests may be adjudged. The DOR subsequently filed this appeal.

**COMMONWEALTH v. WELLS FARGO, ET AL.**

On June 14, 1996, the DOR filed a general state tax lien in the Bullitt County Clerk's office against Joseph A. Clark. At this time, Joseph did not own property in Bullitt County, Kentucky. On November 16, 2001, Joseph and Janet Clark acquired property with the help of a purchase money mortgage from Provident Bank, recorded on November 29, 2001. The mortgage was assigned to Wells Fargo Bank, Minnesota, N.A. ("WFB") by an assignment recorded on February 14, 2003. Subsequently, the DOR filed two more general state tax liens against Joseph on August 24, 2004, and October 20, 2004. On November 9, 2004, WFB filed a mortgage foreclosure action in Bullitt Circuit Court, against the real property owned by Joseph and Janet. On April 9, 2007, the circuit court cited to *Kentucky Legal Systems Corp. v. Dunn*, 205 S.W.3d 235 (Ky.App. 2006) and ruled in favor of WFB, giving its mortgage first priority of the proceeds from a master commissioner's sale over the prior recorded lien of the DOR. The DOR challenges that decision in this Court.

## II. ANALYSIS

### GENERAL LIEN PRIORITY

It is well settled that the general rule, when it comes to lien preference, is first in time, first in right. *Indiana Truck Corporation of Kentucky v. Hurry Up Broadway Co.*, 1 S.W.2d 990 (Ky.App. 1928). Under this rule, the first creditor to file their lien against a debtor has the first right to the debtor's property. "All bona fide deeds of trust or mortgages shall take effect in the order that they are legally acknowledged or proved and lodged for record." KRS 382.280. However, it has also been held that the legislature may create statutory liens and establish their priorities. *Midland-Guardian Co. v. McElroy*, 563 S.W.2d 752 (Ky.App. 1978).

The law in Kentucky is quite clear that a recorded mortgage takes priority over any subsequent creditors. KRS 382.270, KRS 382.280. It is equally clear that the legislature may create statutory liens and establish the priorities thereof. However, as stated in 51 Am.Jur.2d Liens s 57, in the absence of a statute giving precedence to a statutory lien, its relative rank is determined under the general principle of first in time first in right . . .

*Id.* at 754 (internal citations omitted).

Tax liens are statutorily created by KRS 134.420, which reads, in relevant part:

(2) If any person liable to pay any tax administered by the Department of Revenue, other than a tax subject to the provisions of subsection (1) of this section, neglects or refuses to pay the tax after demand, the tax due together with all penalties, interest, and other costs applicable provided by law shall be a lien in favor of the Commonwealth of Kentucky. The lien shall attach to all property and rights to property owned or subsequently acquired by the person neglecting or refusing to pay the tax.

(4) The tax lien imposed by subsection (2) of this section shall not be valid as against any purchaser, judgment lien creditor, or holder of a security interest or mechanic's lien until notice of the tax lien has been filed by the commissioner of the Department of Revenue or his delegate with the

county clerk of any county or counties in which the taxpayer's business or residence is located, or in any county in which the taxpayer has an interest in property. *The recording of the tax lien shall constitute notice of both the original assessment and all subsequent assessments of liability against the same taxpayer.* Upon request, the Department of Revenue shall disclose the specific amount of liability at a given date to any interested party legally entitled to the information.

(Emphasis added).

### **EQUITABLE SUBROGATION**

The doctrine of equitable subrogation has long been recognized in Kentucky. *Louisville Joint Stock Land Bank v. McNeely*, 102 S.W.2d 389 (Ky.App. 1937). The doctrine is the practice of which a creditor who pays debt for which another is primarily responsible is substituted, or subrogated, to all rights and remedies of the original creditor. *Black's Law Dictionary*, 6th ed. 1990, 539. In the case of *Commonwealth v. Central Bank, et al.*, the MC, finding the facts to be identical to *McNeely, supra*, granted Central first priority, to the extent their loan paid off CBT's lien. The issue which this presents to the Court is: does a lien, given preference by way of equitable subrogation, remain preferential over a later-filed tax lien? We hold that it does not.

This Court has held that under KRS 134.420(2) a tax lien has preference over a purchase money mortgage, when tax liens were filed prior to the mortgage. *Liberty Nat. Bank and Trust Co. of Louisville v. Vanderkraats*, 899 S.W.2d 511 (Ky.App. 1995). Priority is given to a bona fide purchaser until the tax lien is filed, at which time the DOR is given priority. *Id.* The Court also held that a lender has an opportunity to protect itself by requiring that tax liens be fulfilled prior to lending money, a protection extended by the filing requirement of KRS 134.420(2). *Id.* The holding of *Vanderkraats, supra*, was later reiterated by the Court, when again holding that the DOR has priority

over subsequent mortgages. *Com., Revenue Cabinet v. Hall*, 941 S.W.2d 481 (Ky.App. 1997).

In the case sub judice, Central was given notice of the tax obligation prior to filing their mortgage. The protection created by the statute is for those parties that are not on notice. Therefore, equitable subrogation will not defeat priority given by statute, because the subrogation does not make the notice cease to exist.<sup>6</sup>

### **PURCHASE MONEY MORTGAGES**

In *Commonwealth v. Wells Fargo Bank, et al.*, the trial court, looking to *Dunn*, 205 S.W.3d at 236, found that a purchase money mortgage is superior to all other liens. We disagree. The Court in *Dunn*, held:

[a] vendor's purchase money mortgage is senior to any previous judgment liens that arise against the purchaser-mortgagor. This is true even though a judgment attaches as a lien to the judgment debtor's after-acquired real estate and the vendor takes the mortgage with actual knowledge of the judgment. . . . Because this long-established rule makes it unnecessary for a purchase money lender to examine for preexisting judgments and other liens against the purchaser-mortgagor, it reduces title risk in connection with such transactions and thus encourages purchase money financing by vendors. Moreover, the rule is justified on grounds of fundamental fairness.

*Id.* The case sub judice is distinguishable from *Dunn*, because the lien present here is a tax lien, not a judgment lien. At oral argument, it was argued by Central that tax liens work like judgment liens. We disagree. Judgment liens and tax liens are created by two different statutes. Judgment liens are created by KRS 426.720, which does not, like the tax lien statute KRS 134.420, create a priority for them. As previously discussed, KRS 134.420 creates a priority for tax liens upon filing, specifically because a later-filing lender has notice. Furthermore, judgment liens are typically created when one party

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<sup>6</sup> See also *Louisville/Jefferson County Office for Economic Development v. Manufacturers And Traders*, 2004 WL 259083 (Ky.App. 2004), in which the Court held that equitable subrogation does not defeat a priority when there was notice of a prior lien and no subordination agreement existed.

receives a benefit, such as property or services, from a voluntary lender and fails to compensate the lender for it. The DOR, which provides benefits for all of the Commonwealth, is not a voluntary lender. Our position is further supported by the language in *Dunn*, which states:

we hold that Kentucky should adopt this logical rule that third parties who lend money used to purchase real estate in exchange for a mortgage hold special priority over all other recorded liens and judgments *except where agreed otherwise by the parties or specified by statute*.

*Id.* at 237 (emphasis added). We believe that the priority created by KRS 134.420 is exactly the type of exception accounted for in the holding of *Dunn* and addressed by the prior holdings of *Vanderkraats, supra* and *Hall, supra*, as further evidenced by the Court's failure to address either of those prior-decided cases relating to tax liens.

### **III. CONCLUSION**

Based on the foregoing, we hold that the circuit courts erred in re-ordering the lien priorities. Accordingly, we reverse the November 30, 2006, judgment of the Jefferson Circuit Court and remand this matter for entry of an order in conformity with this opinion. Additionally, we reverse the April 9, 2007, judgment of the Bullitt Circuit Court and remand this matter for entry of an order in conformity with this opinion.

ALL CONCUR.



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