

Priority of Creditor Claims Against Estates

By Bruce M. DiCicco

Priority of Payment in General

The Surrogate's Court Procedure Act 1811 sets forth priorities for the payment of estate expenses and debts. This statute is relevant to estate administration when assets are not sufficient to satisfy all the estate expenses and/or debts, and is critical to the enforcement of creditor claims against an estate. The legal issues relating to priority require a careful analysis and understanding of this statute, the meaning of which can be surprisingly counter-intuitive. This article discusses statutory priority granted to debts owed to New York State and New York City public welfare officials, the effect the type of property held in the estate may have on those priorities, and the effect the doctrine of equitable liens may have on those priorities. First we should look at the payment hierarchy set forth in the law.

Section 1811(1) gives express priority to the payment of funeral expenses and expenses of administration out of the first moneys received by the fiduciary. Debts of the decedent are then ordered as follows:

Section 1811(2)(a) gives first priority to debts entitled to a preference under the laws of the United States and the state of New York ("Priority One");

Section 1811(2)(b) gives second priority to taxes on property assessed prior to death ("Priority Two");

Section 1811(2)(c) gives third priority to "Judgments docketed and decrees entered against the decedent according to the priority thereof respectively" ("Priority Three"); and

Section 1811(2)(d) gives last priority to all recognizances, bonds, sealed instrument, notes, bills and unliquidated demands and accounts ("Priority Four").

Following these ordering provisions comes the directive in SCPA 1811(3) that "Preference shall not be given in the payment of a debt over other debts of the same class, except those specified in subparagraph (c) of subdivision 2." In other words, Priority One and Two debts in excess of estate assets would be apportioned while Priority Three debts (Section 1811(2)(c)) are not apportioned, but rather preference is given according to the priority of the debt within that class.

Statutory Priority for the Public Welfare Official

One might suppose that in determining preference among Third Priority debts a "first-in-time, first-in-right" rationale might apply, akin for instance to the concepts of logic applicable to land title recordation. But as we shall see, this logic is not controlling, since

debts granted statutory priority at times take precedence over recorded judgments prior in time. Two such statutes are Section 105 of the Social Services Law (formerly Section 129 of the Public Welfare Law) and Section 104 of the Social Services Law (formerly Section 128 of the Public Welfare Law). Section 105 expressly grants the Department of Social Services (Human Resources Division) a priority for its claims and provides:

If person who has received relief and care at public expense, shall die leaving insurance, and the estate of the insured is named as beneficiary, or no beneficiary is named, the public welfare official shall be entitled to a *preferred claim* (emphasis supplied) to be paid out of such insurance to the amount of the cost of such relief and care, and for funeral expenses not to exceed one hundred and twenty-five dollars. If the insured leaves a widow or minor children who are, or are liable to become, public charges, the public welfare official may, in his discretion, waive his claim to such insurance or any part thereof to which he would otherwise be entitled.

Section 104 of the Social Services Law provides in relevant part:

A public welfare official may bring action or proceeding against a person discovered to have real or personal property, or against the estate of the executors, administrators and successors in interest of a person who dies leaving real or personal property. . . .

In all claims of the public welfare official made under this section the public welfare official shall be *deemed a preferred creditor*. (emphasis supplied)

Litigation over priority has ensued not only under the current statutes but also under their predecessor enactments and serves to highlight the substantial uncertainty in this area of the law. The case of *In re Ciappei's Estate*¹ was decided under the Sections of the old Surrogate's Court Act that provided for priority of payments from estates. Sections 216 and 222 directed that funeral and administration expenses should be paid from the first estate moneys, as does SCPA 1811(1) today. Section 212(1) of the old Act directed

that the third highest priority (Sections 216 and 222 being the first two) was "debts entitled to preference under the laws of the United States and of the state of New York, pursuant to Section 212 subd.1." This language is essentially the same as current First Priority (Section 1811(2)(a)). The *Ciappei* court stated:

It is clear from the provisions of Section 129 of the Public Welfare Law that claims for reimbursement for payments for relief are included in the third group, as enumerated above, since they are entitled to a *preference* (emphasis supplied) under the laws of the state of New York. The claim of the city is thus entitled to priority over the claim of judgment creditors.

The court held that the claim of New York City came before the claims of a previously docketed judgment creditor since the claim of the City was a preference granted by law. The assets making up the estate of Mr. Ciappei were the proceeds of life insurance, and thus the case was later held to be limited to estates where the assets from which the claims of creditors were to be satisfied came from the proceeds of life insurance.² Thus, claims of the public welfare official could have priority of payment from an estate where life insurance was the asset from which the State or City sought payment.

However, other courts expanded the priority of the public welfare official beyond estates funded with life insurance proceeds. In *Clonan's Estate*,³ the estate had insufficient assets to pay the claim of the Department and other general creditors. The assets of the estate were not made up of life insurance proceeds but of other intangible assets. The court first dealt with the absence of the "preferred creditor" language in then Section 128 of the Public Welfare Law, holding that Section 128 and Section 129 should be read *in pari materia*. Thus the court reasoned that there should be no distinction between estates holding life insurance proceeds and those holding other assets when it comes to priority of payment in favor of the public welfare official. The court found that the claim of the Commissioner of Public Welfare came before other creditors since it was a preference under the laws of the State of New York.

Other cases dealing with the statutory priority issue focused on whether or not the debt was due to New York State in its capacity as a sovereign public welfare official and thus entitled to the statutory preferences of Sections 104 and 105. For instance, in the case of *In re Stewart's Will*⁴ judgment was obtained against the decedent during his lifetime. The State of New York claimed preference by virtue of having rented office space to the decedent for which he remained indebted

at the time of his death. The court found for the creditor, holding that:

The State had pointed to no statute or decision under which it is indicated that the debt is entitled to preference. It must be borne in mind that the debt is not one for taxes or other revenue nor is it for an obligation incurred in the exercise by the State of its sovereign or governmental functions . . . to support a preferential status under the statute, the intent of the legislature to accord such a status should be clearly expressed.⁵

The decisional history shows that in order to obtain preference over other debtors, specific statutory entitlement must be shown to exist. Perhaps the clearest statement of this point was made in *In re Hermans' Will*.⁶ The matter involved the New York City Commissioner of Hospitals, who claimed a preference from an insolvent estate based on Section 104 of the Social Services Law following the addition in 1964 of the preferred creditor language (for a debt that arose prior to the effective date of the amendment).⁷ The court squarely dealt with the meaning of the new amendment and the addition of the "preferred creditor" language. The court stated:

Prior to the 1964 amendment there were conflicting decisions concerning the right to a preference to public welfare claims. *Clonan's Estate*,⁸ *In re Andrews*,⁹ *In re Smith*,¹⁰ *In re Cornez*.¹¹ The statute resolves the conflict, but shows no purpose to operate retroactively in pending estates.

Although the Commissioner lost due to the fact that the amendment did not apply retroactively, the court spoke directly to the intended effect of the preference language added to the statute. From a reading of the cases, it is clear that the Department of Social Services is entitled to a preference over all other Third Priority judgment creditors of an estate pursuant to Section 104 and/or Section 105 of the Social Services Law, and that executors must pay those claims first even though they arise later in time than earlier filed claims of judgment creditors.

Defeat of the Statutory Priority of the Public Welfare Official for Specific Prior Liens

In *Estate of Livingston*,¹² the court addressed competing claims of two judgment creditors: one who did not move past docketing its judgment and one who caused an execution to issue and levied upon tangible personal property prior to the death of the judgment

debtor. The court held that the creditor who executed on its judgment had priority, and in dicta commented upon the fact that the winning creditor might have had a preference over the State of New York based upon its "specific prior lien."

Many of the Third Priority cases do not mention this aspect of equity nor do they include an analysis of the type of property held in the estate. One can easily be misled by pronouncements of the Department of Social Services priority in these cases without realizing that there is a class of creditor that may have priority over the public welfare official notwithstanding the seemingly absolute priority language of the above quoted statutes. Indeed the cases reveal many litigants being so misled, including the Department of Social Services.

In *In re Pierce*,¹³ the court was focused on the priority of estate debts in the context of the Department of Social Services lien and its asserted statutory priority. The decedent was a patient in the hospital prior to her death, incurring medical bills of \$29,000. The hospital obtained two judgments against the patient for the unpaid hospital bills during her lifetime. The first judgment was docketed on December 11, 1981 and the second on March 31, 1982. Following the death of the decedent the Department of Social Services filed a claim against the estate of the patient for \$59,332 for care rendered to decedent prior to her death. Estate assets were insufficient to pay the judgments and the claim in full. The sole issue before the court was priority of the creditors. The public welfare official relied first on Social Services Law Section 104 and the 1964 addition to the statute, citing *In re Ciappei's Estate*.¹⁴

The *Pierce* court did not even discuss the change in Section 104 of the Social Services Law in reaching its holding in favor of the hospital. Instead, the court found that the hospital, as judgment creditor, held a "specific prior lien" by virtue of the fact that the estate contained a parcel of real property. The court observed "that when the hospital filed its judgments prior to the death of the decedent, and prior to the filing of the claims of the Department of Social Services, said judgments became a specific lien on the decedent's real estate." The court left no doubt as to the grounds for its ruling, and pointed out that it was not necessary for the hospital, after filing its judgment, to issue an execution in order for its lien to attach to real estate held in the estate. This is so, explained the court, because under CPLR Section 5203, relating to priority and liens on docketing judgments, the transfer of real property by the judgment debtor is not effective as against the judgment creditor until ten years after the filing of the judgment. In other words, the lien attaches to real estate when filed. *Pierce* was appealed to the Appellate Division, where the court held in a one paragraph memorandum decision that the preference granted

under Social Services Law Section 104 was only as to general creditors.¹⁵

Executors are thus instructed that where the estate is made up of personal property, the Department, operating under Section 104 or Section 105 of the Social Services Law, will take priority over judgment creditors who have not executed on the judgment. A case in point is *Estate of Patrick Pizzirusso*,¹⁶ where a judgment creditor obtained and entered a judgment before the death of the decedent. The estate consisted solely of personal property that was insufficient to pay both debts. The judgment creditor, no doubt thinking "first-in-time equals first-in-right," served the executor with a restraining notice seeking to enforce his earlier filed claim over that of the Department of Social Services. The sole issue was which claim took.

The respondent judgment creditor claimed that his debt came first because it was a specific lien against decedent's property that had been filed of record before decedent's death pursuant to CPLR Article 52. The court disagreed, and explained that whereas liens against real property indeed attach at the time of docketing the judgment, in the case of personal property additional post-docketing steps are required in order to obtain priority rights over the personal property of the debtor. The judgment creditor must have an execution to a sheriff or have utilized other devices found in CPLR Article 52, such as CPLR 5202 (relating to delivered executions to a sheriff), CPLR 5225 (relating to possession of personal property by the sheriff) and CPLR 5228 (relating to appointment of a receiver) in order to have prevailed as against the Department and its statutory priority. The court reasoned that the service of the restraining notice on the executor did not cause the lien to attach to the personalty held in the estate because there was no specific property "seized and appropriated" for the satisfaction of the debt until there was further execution on the judgment. There was, thus, no specific prior lien.

The decision in *In re Robinson*¹⁷ presents another articulation of the principle. The debtor patient had entered into an agreement with the creditor nursing home to satisfy fees for services rendered by the home. The agreement specifically provided for the satisfaction of the nursing home debt from the sale proceeds of a residence owned by the patient and another person as tenants-in-common. The agreement to pay the debt was not reduced to a judgment nor was any judgment ever docketed. Following the creation of the agreement, the patient received substantial Medicaid, then died on December 3, 1998. The Department of Social Services filed its claim against the estate in February 1999. The executrix of the estate waited the statutory period of 7 months after issuance of Letters before paying the claim of the nursing home.¹⁸ The court stated that had the home obtained a judgment and docketed it, the

claim of the Department of Social Services would have been subservient to a creditor with a "specific prior lien" since the lien would have attached to the real estate at the time it was first docketed.

The *Robinson* case, the *Pizzirusso* case, and others like them, seem to set down a black letter rule to the effect that statutory preference defeats prior docketed judgments in all cases except where there is real property held in an insolvent estate or where the judgment debtor has executed by one of the devices under CPLR Chapter 52. Upon closer examination of the decisional history, however, yet another factor emerges that affects the ultimate outcome in Third Priority cases.

Specific Prior Lien Preference Could Apply to Property Other Than Real Property

Many cases in this area of the law rely on the Appellate Division decision in *Pierce* without further support, and thus this one paragraph decision merits further analysis. The *Pierce* decision only cited two cases in support of its affirmance, *In re Warren* (a/k/a *Matter of Bloomfield*)¹⁹ and *In re Lambert* (a/k/a *Matter of Gallucci*).²⁰ In *Warren*, the court was deciding a dispute between New York State and New York City as to which would have priority for reimbursement for the cost of care provided to an incompetent.²¹ The court held that New York State, by virtue of Section 35 of the New York Constitution of 1777 and the common law of England, was a sovereign, succeeding to the Crown's prerogative right of priority and thus prevailed over the City.²² In *re Lambert* held that the claim of the Office of Mental Health came before, and thus had a preference over various unspecified creditors, there being no specific prior liens. The decision is one paragraph in length and simply states the conclusion with citations to three cases: *Wise v. Wise L&C Co.*,²³ *In re Gruner*,²⁴ and *In re Carnegie Trust*.²⁵ *Wise v. Wise L&C Co.* did not involve any preference right granted by statute. In *re Carnegie Trust* found a preference for the New York State treasurer where a special fund was created by statute. The court stated that such a priority might not exist in the event there was a specific prior lien. In *Gruner*, the debtor assigned his ownership in his seat on the New York Stock Exchange for a loan of \$212,000. The value of the seat was security for the loan pursuant to the assignment. The seat was later sold by the administratrix of his estate. The assignee, New York Trust Co., claimed its debt had priority over those of the United States and New York State for unpaid income taxes of the decedent even though the debt of the trust company had not been reduced to judgment, but was an assignee right. The court explained:

Perhaps it should be pointed out to avoid misunderstanding that, even if the lien had been perfected prior to decedent's death, it still might not be a

"specific" lien within the meaning given to that term by the Federal courts when dealing with the priority of the United States under Section 3466 over the statutory lien of State taxes, where no specific property has been seized and appropriated to the satisfaction of the lien or set apart from the general property of the debtor.

So in finding for the United States and New York State over the assignee, the court pointed out that certain liens could defeat even statutory priorities (i.e., the public welfare official, New York State and even the United States) but only where specific property of the debtor has been separated and applied to the satisfaction of the lien. While this case does support the personal property vs. real property distinction in Third Priority law and the *Pierce* touchstone, it is not without its detractors. The detractors cause one to more carefully consider when property has been so separated and applied as to constitute a specific prior lien.

Equitable Lien Theory Has Been More Broadly Applied

Illustrative of the question is the case of *Stathos v. Murphy*²⁶ that has been cited with approval consistently many times since the decision forty years ago. In this case the court provided a thoughtful analysis of the concept of the class of equitable liens that could operate as specific prior liens. The court distinguished (i) future claims that do not take effect when the right arises or the capacity to transfer the right arises, that do not result in an equitable lien and (ii) present claims not yet matured or dependent on future conditions even though there is not an immediate action at law available to enforce the claim. In the case, the court held that an assignee of the right (but not a judgment) to the proceeds of a pending lawsuit were present claims that gave rise to an equitable lien that defeated the right of a judgment creditor whose right arose later in time than the assignment. The interpretation of "equitable lien" may not, therefore, be limited to real property and property upon which an execution has been effected as suggested in *Pierce* and *Estate of Patrick Pizzirusso*, but rather may include situations where specific property subject to the lien has been "set apart and identified" equitably. The situation has often arisen in cases where loans were made in exchange for the assignment of rights to property. This aspect of Third Priority claims seems therefore to require careful analysis beyond the real property vs. personal property dichotomy set forth derived from *Pierce*. Counsel for executors should carefully examine the underlying facts of the claim and the nature of the property held in the estate prior to making the determination as to order of payment from insolvent estates.

Endnotes

1. 287 N.Y.S. 988 (Sur. Ct., N.Y. Co. 1936).
2. *In re Nifeneger's Estate*, 177 Misc. 198, 30 N.Y.S. 178 (Sur. Ct., Monroe Co. 1941); *In re Smith's Estate*, 1 Misc. 2d 657, 177 N.Y.S. 2d 767 (Sur. Ct., Fulton Co. 1958).
3. 176 Misc. 557, 28 N.Y.S.2d 88 (Sur. Ct., Orange Co. 1941).
4. 109 N.Y.S.2d 609 (Sur. Ct., Kings Co. 1951).
5. The court did note that the rent attributable to the period following issuance of Letters was an administration expense that was thus entitled to payment before the judgment creditor under Priority One.
6. 44 Misc.2d 585, 254 N.Y.S.2d 484 (Sur. Ct., Kings Co. 1964).
7. Prior to 1964, the language of the third Section of paragraph (1) in Section 104 quoted herein above was not included. This is the "preferred creditor" provision added by L 1964 Ch. 573 § 1. Letters and memoranda contained in the legislative bill jacket indicate that it was the express purpose of the amendment to give priority creditor status to the Department just as was already contained in Section 105. *Memorandum from the State of New York Banking Department dated April 13, 1964*; *Letter from the Surrogate's Association dated April 6, 1964*; *Letter from the Association of the Bar of the City of New York dated April 14, 1964*.
8. 176 Misc. 557, 28 N.Y.S.2d 88 (Sur. Ct., Orange Co. 1941).
9. 179 Misc. 876, 40 N.Y.S.2d 81 (Sur. Ct., N.Y. Co. 1942).
10. 11 Misc. 2d 657, 177 N.Y.S.2d 767 (Sur. Ct., Fulton Co. 1958).
11. 27 Misc. 2d 671, 207 N.Y.S.2d 343 (Sur. Ct., Kings Co. 1960).
12. 211 N.Y.S.2d 897 (Sur. Ct., N.Y. Co. 1961).
13. 472 N.Y.S.2d. 275 (Sur. Ct., Onondaga Co. 1984), *aff'd*, 483 N.Y.S.2d. 500 (App. Div., 4th Dep't 1984).
14. The Department also argued that the New York Constitution, Article 1, Section 14, gives New York State the prerogative over rights of its subjects which entitles it to a priority in payment of debts owed, and the fact that the Surrogate's Court must grant leave to execute on a judgment whenever the debtor has died as required under CPLR Section 5208.
15. 483 N.Y.S.2d 500 (App. Div., 4th Dep't 1984).
16. N.Y.L.J., Nov. 11, 2005, p. 34, col. 2. (Sur. Ct., Westchester Co.).
17. 754 N.Y.S.2d 525 (Sur. Ct., Nassau Co. 2003).
18. Note that the executor therefore knew of the alleged Medicaid claim but purposely did not pay it.
19. 53 N.Y.2d 118, 440 N.Y.S.2d 609 (1981).
20. 87 A.D.2d 818, 448 N.Y.S.2d 767 (A.D., 2d Dep't 1982).
21. Paul Powers, Secretary of the Surrogate's Court Association, in a letter to the Hon. Sol Neil Corbin, Counselor to the Governor of the State of New York, communicated his disapproval of the 1964 Amendment to Social Services Law Section 104 and correctly predicted that this issue would be litigated.
22. The court commented upon the priority language of Section 104 of the Social Services Law and stated that the purpose of the statute was to render a priority over the "general creditors" of a decedent citing to the New York State legislative history found at N.Y. Legis. Ann. 1964 p. 322. That history states: "The proposed bill would clarify the intent of the section and would give public welfare claims clear preference over the claims of other general creditors. . . . The proposed bill would also entitle claims of the public welfare official to priority under Section 212 of the Surrogate's Court Act, which sets up classes of preferences. As amended, the section would grant a preference under the Surrogate's Court Act in the same manner as in Section 21(1) Surrogate's Court Act: "Debts entitled to a preference under the laws of the United States and the State of New York."
23. 153 N.Y. 507 (1897).
24. 295 N.Y. 510 (1946).
25. 206 N.Y. 390 (1912).
26. 276 N.Y.S.2d 727 (App. Div., 1st Dep't 1966).

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