

NEW STRUGGLES IN UNDERSTANDING THE PRIORITIES
BETWEEN TAX LIENS AND SECURED LENDERS

SOME PITFALLS, REMINDERS & GUIDELINES

The due diligence, lien searches and UCC checks are complete at the Delaware Department of State and all seems clear. But is it? Were the proper jurisdictions searched for state tax liens as well as federal tax liens and, if they were, what about a tax lien that comes into existence after the loan closes—can the priority in after-acquired accounts receivable or the blanket security interest in equipment be cut off?

The priority of a perfected, senior secured lender may be impacted by the existence of a tax lien upon the borrower's assets. Federal tax law and a recent federal court case erode the certainty of first-in-time-first-in-right priorities and commonly accepted lien search logic. In this Alert we highlight the differing standards to locate state tax liens as opposed to federal liens and, assuming the slate was clean at closing, the risks to subsequently acquired accounts receivable, inventory, equipment or other *after-acquired* collateral supporting loans secured by floating liens.

The Federal Tax Lien Act ("FTLA") requires that the Internal Revenue Service make a demand for any unpaid delinquent taxes. Once that demand is made, a federal tax lien arises automatically upon the neglect, failure or refusal of a taxpayer to pay its taxes. Nonetheless, the IRS may only enforce this lien over any purchaser, secured party, mechanic's lien or judgment creditor if a notice of the lien is properly filed. Federal tax liens, however, do not automatically have priority over all other liens. For instance, a secured lender will prevail if its perfection predates the notice filing by the IRS if the collateral is *in existence* at the time the loan or lease closes, i.e., a lender that does not seek a security interest in after-acquired property such as with a blanket lien on equipment or a continuing security interest in accounts receivable or inventory. The real dilemma for secured lenders is: What impact can a federal tax lien have on after-acquired property—those assets that come into existence after the loan closes and is funded?

The FTLA provides at Section 6323(c) for a so-called '45 day rule' such that upon the filing of the notice of lien, the federal tax lien will have seniority against property of the borrower subject to an existing after-acquired security interest which comes into existence 46 days after the tax lien filing. So it seemed that a lender had a 45 day window to uncover the tax lien before continuing to fund under a classic revolving credit facility before its lien is primed by the federal tax lien. *Vigilance in post-closing tax lien searches for lenders who rely on after-acquired collateral or blanket liens is crucial*. However, a recent case held that a prior perfected security interest in after-acquired property may take a back seat to a federal tax lien that is filed after the perfection of the security interest, thereby allowing the IRS to surpass the UCC's 'first in time, first in right' rule. See, Old National Bank v. RCH Electronics Systems, Inc., 2005 WL 435479 (S.D. Ind. 2005). In Old National Bank, the Court found that the lender's interest in the accounts receivables arose once the debtor gained rights in the asset. As such, because the IRS had filed its notice before the receivables came into existence, but after the perfection of the bank's lien, both the bank's lien and the IRS' lien attached simultaneously - - the minute the debtor gained rights to the receivables. The Court concluded that the secured lender lost its priority battle with a tax lien when both interests attached simultaneously. In reaching this decision, the Court relied on the U.S. Supreme Court case of United

States v. McDermott, et al., 507 U.S. 447 (1992). However, we believe that reliance was misplaced because the U.S. Supreme Court case involved a judgment lien (as opposed to a consensual lien) which is not subject to the FTLA's 45 day rule protecting secured lenders.

It would appear that had the Indiana Court undergone the analysis under 6323 (c) of the FTLA, the prior perfected secured lender would have prevailed to the extent of collateral that came into existence within 45 days after the IRS' filing of its lien. As such, the secured creditor's right to proceeds in account receivables would prevail in a priority battle with the IRS even after the 46th day (so long as the security interest is in compliance with Section 6323 (c) of the FTLA) and the receivables or collateral came into existence prior to the 46th day after the filing of the federal tax lien.

Are the rules different for state tax liens? State tax liens vary with regard to the priority they maintain over consensual security interests. State law will control the ability of a state tax lien to cut off priority that a consensual secured lender maintains in after-acquired property and the benefits afforded to the IRS in the FTLA do not confer rights on the state taxing authorities. In New York, for example, no corollary exists to the priming nature of the FTLA in after acquired property. Other states, however, provide that taxes on property shall be a first lien upon the property of the person to whom the taxes are assessed.

Can the state tax lien be uncovered with conventional search techniques? In New York, changes to the Tax Law have not followed the changes to Article 9 of the UCC. *Searching for tax liens with the same search logic used for UCC financing statements will not work.* The filing of the New York State tax lien involves the state tax commissioner issuing a warrant to any sheriff of any county who will then enter the amount due, with penalties and interest, in the judgment docket in the County of the borrower's residence. New York Tax Law § 1092 (McKinney's 2005). This docketed judgment becomes a lien on all real, personal and other property. If the warrant is against personal property, then the New York statute requires that it also be filed with the New York Department of State. The judgment docket will provide a record of a corporation's warrant liens and therefore, a lender that is searching for this information should be looking to the judgment docket.

Like federal lien searches, warrant liens must also be conducted separately from searches of UCC security interests. A searcher must be specifically advised to conduct the appropriate search. Especially given the recent decision in In re Spearing Tool (in which the Sixth Circuit Court of Appeals liberalized the specificity by which the IRS must identify the debtor's name in perfecting its lien), added care in performing pre-closing searches AND properly verifying the continuing "first lien" nature of the security interest post-closing cannot be ignored.

Moritt Hock Hamroff & Horowitz LLP is a broad based corporate law firm with more than 25 lawyers and a staff of paralegals. The firm has extensive experience in litigation; creditors' rights and bankruptcy; real estate law; tax & trusts and estates; direct marketing, advertising & new media; intellectual property & unfair competition; general corporate, financial services, secured lending & leasing.

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