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SECURED LENDING ALERT

THE PERILOUS FEDERAL TAX LIEN

Secured lenders need to be extremely vigilant regarding the risk of being primed by federal tax liens. Even though a secured lender has properly perfected its first priority security interest in all assets of its borrower, it can still be primed by a federal tax lien filed after the lender's security interest is perfected as to certain future advances made by the lender and as to certain after-acquired collateral. Although this risk is particularly high for revolving loans due to the twin 45-day rules described below, such risk is not limited to revolving loans and can also apply to multi-disbursement loans and delayed disbursement loans, where advances may ultimately be made more than 45 days after the lender's federal tax lien search.

It is prudent for all lenders to periodically review the basic rules pertaining to federal tax liens. The failure to pay federal income, withholding, social security or other federal taxes leads to a delinquency assessment against the taxpayer, which assessment constitutes a lien in favor of the United States upon all property and rights to property belonging to the taxpayer on the date of assessment. Fortunately, such lien does not become valid against third parties (including secured parties), until a notice of federal tax lien is filed in the appropriate office.

1. PLACE TO FILE AND SEARCH FOR A NOTICE OF FEDERAL TAX LIEN.

The requisite place to record (and search for) a notice of federal tax lien in Illinois depends on the type of property involved and the type of taxpayer:

For Filings Against Real Property - the proper place to record (and search for) a notice of federal tax lien in the State of Illinois is in the office of the Recorder of the county where the real property is located.

For Filings Against Personal Property (whether tangible or intangible) - the proper place to record (and search for) a notice of federal tax lien in the State of Illinois is as follows:

(a) Corporations and Partnerships (whose principal executive office is in Illinois), Trusts and Decedent's Estates - the office of the Secretary of State of Illinois (effective August 15, 1989).

(b) All other taxpayers - in the office of the Recorder of the county where the taxpayer resides at the time of filing of the notice of lien.

It is interesting to note that the Uniform Federal Lien Registration Act, as adopted in Illinois, was never amended to require federal tax liens against limited liability companies, to be filed in the office of the Illinois Secretary of State (770 ILCS 110/2). Thus, a federal tax lien filed in Illinois against a limited liability company would be filed in the Recorder of the county where the limited liability company "resides" (presumably where it has its principal office).

The Commerce Clearing House (CCH) Federal Tax Reporter contains an invaluable "all-state table" of proper filing offices to search for federal tax liens. The writer has observed that some search services are not often aware of the proper office to search for federal tax liens for the particular type of collateral or taxpayer involved. Fortunately, it has become a common practice for lenders to obtain tax lien searches in both the state and county offices, which avoids the risk of picking the wrong office to search for federal tax liens.

It should be noted that a notice of federal tax lien in general must be re-filed at 10-year intervals.

2. GENERAL RULE OF PRIORITY.

The basic priority rule is that a lender will have priority ahead of the IRS in collateral owned by its borrower on the date of the federal tax lien filing, if the lender's security interest in such collateral is perfected prior to the date of the federal tax lien filing. Stated another way, by virtue of the tax lien filing, the IRS will gain priority in all of the borrower's collateral acquired by the borrower after the federal tax lien filing. Important exceptions to this general priority rule are discussed below.

3. THE TWIN 45-DAY RULES.

Under Section 6323(c) and Section 6323(d) of the Federal Tax Lien Act of 1966 (the "FTLA"), special priority is given to (i) certain Article 9 security interests that come into existence after the tax lien filing (i.e., certain after-acquired collateral), and (ii) certain future advances made after the tax lien filing, respectively.

In order to qualify for the superpriority for after-acquired collateral, the collateral must be (1) Qualified Property (as defined below) covered by a (2) Commercial Transactions Financing Agreement (as defined below) entered into before the tax lien filing, and that (3) is properly perfected under the Uniform Commercial Code (the "Code") as of the time of the tax lien filing.

"Qualified property" under the FTLA means "commercial financing security" - negotiable instruments, accounts receivable, executory contract rights, chattel paper, securities, documents of title, and inventory (including raw materials and goods in process). This superpriority does not apply to goods other than inventory, such as equipment and farm products, nor does it include general intangibles such as patents and copyrights.

A "Commercial Transactions Financing Agreement" is defined to mean a written security agreement to make loans to be secured by commercial financing security acquired by the taxpayer in the ordinary course of business, but only to the extent that any future advances are made within 45 days after tax lien filing and before the lender has actual knowledge of the filing.

The following twin 45-day rules protect a lender as to both optional future advances and after-acquired property made or acquired within 45 days after the tax lien filing, provided the three requirements in the third preceding paragraph have been met:

(a) 45-DAY RULE AS IT AFFECTS PRIORITY OF FUTURE ADVANCES.

Under Section 6323(d) of the FTLA, a lender is entitled to priority over the IRS as to future advances made by the lender within 45 days after the federal tax lien filing unless the lender has earlier knowledge of such tax lien filing. Another way to state this is that a lender has priority as to future advances for the earlier of 45 days after the federal tax lien filing or actual knowledge of such filing. The IRS has the burden of showing that the lender had actual knowledge of the tax lien filing.

Let's see how this rule works. Assume ABC Bank makes a \$1,000,000 revolving loan to XYZ Corp. on January 1, 2003 and properly perfects a blanket first priority security interest in all present and future assets of XYZ Corp. A notice of federal tax lien is filed against XYZ Corp. in the proper office on March 1, 2003 and the Bank does not become aware of such tax lien filing until June 1, 2003. What is the effect of the federal tax lien filing with regard to the Bank's future advances? Forty-five (45) days after the date of the federal tax lien filing (April 15, 2003), the federal tax lien begins to prime the lender's security interest with respect to all advances made by ABC Bank under the revolving loan after April 15, 2003. As you can see, under the typical revolving loan, the result of not timely discovering a filed notice of federal tax lien can be devastating for the secured lender.

Under the hypothetical above, it should be noted that (i) although the advances made by the Bank within 45 days after the federal tax lien filing would be given priority over the IRS, such priority would only pertain to collateral owned by the borrower on the date

of the federal tax lien filing and also Qualified Property (as defined in Section 3 above) such as after-acquired accounts and inventory, acquired within said 45-day period. The Bank's protected future advances made within said 45-day period would not apply to collateral acquired by the borrower after the federal tax lien filing which does not constitute Qualified Property, such as equipment, general intangibles and farm products, and (ii) as stated earlier, if the Bank learns of the federal tax lien prior the expiration of the 45-day period, the Bank's future advances made after it learns of the federal tax lien filing would be primed by the IRS.

Once a lender discovers that a federal tax lien has been filed, all advances should cease unless and until the federal tax lien is paid and properly released (which means that the original release signed by the IRS is actually filed in the office in which the notice of tax lien was filed). The same principle would also apply to a commercial factor. The factor should stop purchasing accounts until the federal tax lien is paid and released.

(b) 45-DAY RULE AS IT AFFECTS PRIORITY IN AFTER-ACQUIRED COLLATERAL.

Under Section 6323(c) of the FTLA, a lender's security interest in after-acquired collateral is superior to the federal tax lien as to any after-acquired collateral of the borrower which comes into existence within 45 days after the federal tax lien filing. Since Section 6323(c) applies only to Qualified Property (as defined in Section 3 above), this priority section does not apply to after-acquired collateral consisting of equipment, farm products and general intangibles. It should be noted that in contrast to the above-described 45-day rule for future advances, if Qualified Property is acquired within 45 days after the federal tax lien filing, the lender's actual knowledge of the IRS filing is irrelevant for purposes of the 45-day rule for after-acquired collateral.

Let's see how this rule works. Assume ABC Bank makes a \$1,000,000 revolving loan to XYZ Corp. on January 1, 2003 and properly perfects a blanket first priority security interest in all present and future assets of XYZ Corp. A notice of federal tax lien is filed against XYZ Corp. in the proper office on March 1, 2003 and the Bank does not become aware of such tax lien filing until June 1, 2003. What is the effect of the federal tax lien filing with regard to the Bank's priority in the borrower's after-acquired accounts and inventory? Forty-five (45) days after the date of the federal tax lien filing (April 15, 2003), the federal tax lien begins to prime the Bank's security interest in all accounts and inventory acquired by the borrower after April 15, 2003. An exception to this rule is discussed in subsection (c) below.

Since equipment financing is so important to commercial lenders, it is crucial to understand that the twin 45-day rules do not provide a safe harbor for lenders who finance or rely on after-acquired equipment. For example, if ABC Bank makes a loan against "all equipment now owned or hereafter acquired by the borrower" and includes an optional future advance clause in its security agreement, the Bank's future advances made within 45 days of the federal tax lien filing (and without knowledge of the tax lien) are protected, but only with respect to equipment owned by the borrower before the tax lien filing. Any after-acquired equipment acquired by the borrower after the tax lien

filing is not Qualified Property and the IRS will obtain a priority in all such after-acquired equipment. This means that lenders relying on after-acquired equipment should be checking the federal tax lien records every 45 days in order to be certain that the IRS cannot claim a priority. In those cases where the lender's security interest in equipment acquired after the filing of the federal tax lien, qualifies as a purchase money security interest under the Code, the lender may be able to prime the IRS's tax lien. However, whether a purchase money security interest in equipment will prime a federal tax lien is not certain (see Section 5 below).

It is also important to note that the FTLA and implementing regulations strongly suggest that the lender's pre-tax lien security agreement must contain an after-acquired property clause and a future advance provision to take advantage of the priorities established by the twin 45-day rules discussed above. Most security agreements contain these standard provisions and ABC Bank's hypothetical loan to XYZ Corp. discussed earlier is based on the assumption that ABC Bank's security agreement contains these standard provisions.

(c) PRIORITY IN PROCEEDS.

The priority provided by the twin 45-day rules applies to identifiable proceeds of pre-45-day collateral (constituting Qualified Property such as accounts, inventory or contract rights), even though the proceeds arise after expiration of the 45-day period. Thus, accounts arising from pre-45-day inventory or contract rights will be protected. However, commingled cash proceeds arising from the sale of pre-45-day inventory will not be protected if they are not identifiable. In addition, second generation proceeds (proceeds of proceeds) are not likely to be protected.

An important Illinois bankruptcy decision which protected a lender's priority in proceeds of pre-45-day collateral is In re National Financial Alternatives, Inc., 96 B.R. 844 (Bkrctcy. N.D.ILL 1989). In that case, the court held that a secured lender with a perfected security interest in accounts receivable of a borrower was entitled to a priority ahead of a federal tax lien, to the extent that (a) the accounts were themselves acquired by the borrower prior to the expiration of the 45-day period following the filing of the notice of federal tax lien, or (b) the accounts were proceeds of contract rights or inventory acquired by the borrower prior to the expiration of said 45-day period. The term "contract rights" to date has been held to require a written contract.

A number of years ago, the writer was asked on behalf of a secured lender to combat the IRS over priority to an ambulance company's accounts receivable. The accounts receivable in question were clearly created more than 45 days after the federal tax lien filing and the IRS insisted that it had priority in such accounts. Fortunately, upon further investigation, it was determined that the accounts arose under a written contract between the account debtor and the ambulance company which had been entered into prior to the federal tax lien filing. After citing the In re National case to the IRS attorney, the IRS attorney quickly conceded that the secured lender's security interest in the disputed accounts had priority over the IRS's claim.

4. SECTION 6323(d) 45-DAY RULE FOR FUTURE ADVANCES.

In addition to the twin 45-day rules set forth above, Section 6323(d) of the FTLA provides yet another priority provision for lenders, although its scope is limited. Under this Section, a filed tax lien is subordinate to a security interest that comes into existence after a tax lien filing by reason of optional (or mandatory) future advances made within 45 days of such filing. However, this superpriority will apply only when (i) the lender makes the future advance without actual knowledge of the tax lien filing, (ii) the security interest is in property existing at the time of the tax lien filing, and (iii) the security interest is protected under local law against an unsecured judgment lien as of the time of the tax lien filing.

This superpriority is not limited to "Qualified Property", but it is limited to collateral owned by the borrower on the date of the tax lien filing.

5. PURCHASE MONEY PRIORITY.

Lenders qualifying for purchase money priority under the Code do so to prime prior perfected security interests that are filed ahead of them. Another possible benefit of a lender qualifying as the holder of a purchase money security interest under the Code, is that the lender may be able to prime a federal tax lien.

Legal commentators have argued that although the FTLA does not specifically provide that a purchase money security interest will prime an existing federal tax lien, the legislative history makes it clear that a purchase money creditor enjoys priority over a prior filed tax lien on the theory that the taxpayer only acquires the equity in the property. There has also been some case law to support this priority rule. However, the fact that the FTLA itself is silent on this priority issue is unsettling for lenders.

6. ERISA LIEN.

The Pension Benefit Guaranty Corporation ("PBGC"), a division of the United States Labor Department, administers the Employee Retirement Income Security Act of 1974 ("ERISA"). ERISA provides that when an employer fails to meet the financial obligations imposed by a pension plan guaranteed by the PBGC, the employer's assets will be subjected to a lien in favor of the PBGC.

The ERISA lien arises on the date of the termination of the plan and is subject to the same notice filing requirements as is the federal tax lien. Except as otherwise provided by law, the ERISA lien has the same priority as the federal tax lien. A federal tax lien search should pick up any filed ERISA lien.

7. CONCLUSION.

In conclusion, since the IRS is one of the most voracious creditors that a secured lender may face, a case can easily be made that any lender extending revolving credit should obtain a federal tax lien search every 45 days! A similar argument can be made for multi-disbursement loans or delayed disbursement loans, where advances may ultimately be made more than 45 days after the lender's last federal tax lien search (in which case, such searches would be obtained prior to each subsequent advance). Having said this, the writer is aware that very few lenders out there are actually getting a federal tax lien search every 45 days for revolving loans. However, in light of the substantial risk involved and the relatively insignificant cost involved (when compared to such risk), lenders may want to reconsider how often they obtain federal tax lien searches. A federal tax lien search in the Illinois Secretary of State's office provided by one of the national search services is \$20.00. On an annual basis, a search every 45 days comes out to only \$160.00. This is a small price to pay to avoid losing priority to the IRS. At least one national search firm provides "federal tax lien alert searches" meaning that the 45-day searches can be scheduled in advance and do not need to be ordered every 45 days. The annual cost for this alert service for federal tax lien searches would be \$120 according to the national search service the writer contacted.

This article is informational in nature and is not intended to constitute, nor should it be relied upon as, legal advice to any recipient.

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