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LENDING AND RESTRUCTURING ALERT

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Federal Tax Liens: Superlien? No. First in Time, First in Right? Not exactly.

Federal law generally provides that a perfected security interest under the Uniform Commercial Code ("UCC") will prime a subsequently filed federal tax lien. But many commercial lenders are not familiar with some important exceptions to this general rule. The key pitfalls for a less than fully informed lender concern revolving credit or other line of credit facilities, and any kind of financing secured by accounts receivable or inventory.

Federal tax law recognizes "first in time, first in right" priority only for advances made, without actual knowledge of a federal tax lien filing, within 45 days of such filing. Moreover, with certain limited exceptions (such as an obligatory advance under a direct pay letter of credit), an advance made by a lender during this 45-day period, with actual knowledge of the IRS filing, loses priority to the filed tax lien. Although it is not practical for most lenders to run lien searches continually on all of their lines of credit, before advancing new funds to a borrower in financial difficulty, regardless of whether a default has occurred, a lender should run a lien search.

Equally important to lenders engaged in workouts is a different 45-day rule that applies to certain "qualified property," including receivables and inventory collateral (which encompasses raw materials and "goods in process") acquired by the borrower in the ordinary course of business. This rule provides that the "first in time, first in right" priority afforded the lender's UCC filing will not extend to property acquired by the borrower after the 45th day following the filing of the federal tax lien. The lender's priority would also extend to identifiable proceeds received from the sale or other disposition of "qualified property" whether the proceeds are received during or after the 45-day period. However, the lender's priority does not extend to "proceeds of proceeds" received after the 45-day period. For example, if inventory is sold and a receivable is created after the 45-day period has expired, the lender's lien will attach to the receivable, but if the receivable is thereafter collected and the cash is used to acquire new inventory, the lender would not have priority as to that new inventory.

Thus, there is a clear danger that a lender who fails to act quickly following a default may find itself behind the IRS. In effect, the Internal Revenue Code regulations create a kind of "use it or lose it" dilemma. If, during this 45-day period, an accounts receivable or inventory lender fails to either exercise remedies on its collateral or obtain a subordination from the IRS, it may allow the borrower to consume the last collateral for which the lender was actually senior under the 45-day rule.

Furthermore, lenders will lose their priority vis-à-vis the IRS if the proceeds are commingled with other assets of the borrower. Therefore, the establishment of a lockbox would seem advisable in the early stages of almost any workout where accounts or inventory (or other "qualified property," basically items other than fixed assets) are important parts of the lender's collateral.

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