Cohen, Salk & Huvard, P.C.
Attorneys At Law

Bennett L. Cohen
Bruce A. Salk
Bruce K. Huvard
Christyl L. Marsh
Bruce J. Waldman
Richard M. Hoffman
Amanda J. Wendorff

630 Dundee Road, Suite 120
Northbrook, Illinois 60062
Tel 847.480.7800
Fax 847.480.7882
E-Mail csh@cshlegal.com

December 2, 2015

COMMERCIAL LENDING NEWSLETTER

Priming Liens And Other Landmines in Commercial Lending

This article was written for those in the lending field who sometimes feel like they have nothing to worry about when they're about to make that new important loan. Despite a secured lender's customary due diligence, searches, lien perfection and proper documentation, secured lenders still face exposure from priming liens, hidden liens and other landmines in a typical secured lending transaction. The following list is not intended to be exhaustive, but merely an examination of some of the common priming and hidden liens, and other calamities which come to mind. Knowledge of these liens and other landmines can be of great value to the secured lender in loan documentation, liquidation and litigation.

Topic Summary:

1. Federal Tax Liens.
2. State Tax Liens.
3. Lien Creditors.
4. Constructive Fraudulent Transfers.
5. Landlord's Liens.
6. State Possessory Lien Statutes.
7. Surety's Right of Subrogation.
8. Federal Assignment of Claims Act.
9. Perishable Agricultural Commodities Act.
10. Packers and Stockyards Act.
11. Poultry Producers Financial Protection Act.
12. "Hot Goods" Provision of the Fair Labor Standards Act.
13. True Lease vs. Lease Intended As Security.
14. Assignment of a Single Account, Payment Intangible or Promissory Note for Preexisting Indebtedness.
15. Assignment of Insignificant Part of Outstanding Accounts or Payment Intangibles.
16. Sale of Accounts and Chattel Paper.
17. Sale of the Collateral.
18. Debtor's Name Change.
19. Purchase Money Security Interests (Equipment, Inventory and Chattel Paper).
20. Pledged Deposit Account Maintained at Another Financial Institution.

21. Pledged Securities Account Maintained at a Brokerage House or Another Financial Institution.
22. Late Perfection.
23. Liens Affecting Real Estate (Mechanic's Liens, Real Estate Tax Liens and Assessments and Demolition Liens).

---

1. Federal Tax Liens. The general priority rule for federal tax liens 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 or lien in such collateral is perfected prior to the date of the federal tax lien filing. Stated another way, by virtue of the federal 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.

There are two (2) twin 45-day rules that affect a lender's security interest in a borrower's after-acquired accounts and inventory, as well as the priority of the lender's future advances made to the borrower, and these 45-day rules provide lenders with some limited protection against the IRS.

Under Section 6323(c) of the Federal Tax Lien Act of 1966 ("FTLA"), a lender's security interest in the borrower's accounts or inventory is superior to the federal tax lien as to any after-acquired accounts or inventory which come into existence within 45 days after the federal tax lien filing. Thus, lenders are at risk if they make an advance against accounts or inventory on or after the 46th day after the filing of a federal tax lien notice, unless the federal tax lien is paid and released or satisfactorily subordinated to the lender's security interest.

Under Section 6323(d) of the FTLA, a lender is entitled to priority over the IRS as to future advances made by the lender until the earlier of, (i) 45 days after the federal tax lien filing, or (ii) the lender's actual knowledge of such filing. The IRS has the burden of showing that the lender had actual knowledge of the tax lien filing. It should be noted that the lender's protected future advances made prior to the earlier of 45 days after the federal tax lien filing or lender's actual knowledge thereof will only be given priority in, (i) collateral in existence on the date of the tax lien filing, and (ii) accounts and inventory acquired by borrower within 45 days after the tax lien filing. Thus, a lender's protected future advances will not enable the lender to claim a security interest in other types of collateral acquired by the borrower within the 45-day period after the date of the federal tax lien, such as equipment, general intangibles or farm products.

Since many lenders only obtain annual federal tax lien searches on their borrowers, such lenders risk being primed on either after-acquired accounts and inventory or such lenders' future advances under the above-described 45-day rules. Although many lenders do not feel it is practical to perform periodic federal tax lien searches on their revolving loan borrowers every 45 days, it may be prudent, at a minimum, to consider performing more frequent federal tax lien searches on revolving loan borrowers who are deemed "high-risk" by the lender.

In addition to searching the borrower's exact legal name, lenders need to be vigilant and search for potential federal tax lien filings made by the IRS against name variations of the borrower's exact legal name. Under the Sixth Circuit decision in In re Spearing Tool and Manufacturing Co. Inc. 412 F.3d 653 (6^{th} Cir. 2005), the IRS does not have to file the notice of federal tax lien against the exact legal name of the borrower. The Court held that the IRS lien "need not perfectly identify the taxpayer." The Court determined that in evaluating an IRS filing, the critical issue is "whether a reasonable and diligent search would have revealed the existence of the notices of the federal tax liens under these names." The court concluded that the bank had not conducted a "reasonable and diligent" electronic search because it failed to search common variations of the corporate name of the debtor, and as a result, the notices of IRS tax liens were sufficient under federal law, and the IRS's lien had priority over the bank's lien. As a result of this case, lenders are encouraged to obtain a federal tax lien search on the borrower's exact legal name and all possible name variations (including any name used in the borrower's past federal income tax returns and in borrower's E.I.N. application and any abbreviated names of the debtor to the extent that the relevant state's search logic is not broad enough to capture the same).

2. <u>State Tax Liens</u>. In Illinois, recorded state tax liens will not prime an earlier perfected security interest. For state tax liens in other states, the applicable state statute and case law must be examined to determine whether a state tax lien in such states can prime an earlier perfected security interest. For example, (a) in Colorado, a state tax lien can prime an earlier perfected security interest, and (b) in New York, a state tax lien is treated like a judgment lien (discussed generally in Section 3 below), and such state tax lien can prime the priority of a secured party's future advances to its borrower made more than 45 days after such state tax lien is filed unless the credit was extended by the secured party without knowledge of the tax lien or pursuant to a commitment entered into without knowledge of the state tax lien.

3. <u>Lien Creditors</u>. Before discussing the UCC priority rules for lien creditors, it is important to determine when an unsecured general creditor becomes a "lien creditor." Unfortunately, it is necessary to look to the law of each state to determine precisely at what time an unsecured general creditor becomes a lien creditor for purposes of the UCC's priority rules. The rules vary from state to state. In one state, a creditor's lien can arise against property upon the filing of a lawsuit. In another state, a creditor's lien can arise against property when a judgment is obtained. In another state, a creditor's lien can arise against property when a writ of execution is issued or returned, while in other states, a creditor's lien may not arise against property until the sheriff actually levies upon the property by seizing possession.

Fortunately for lenders, in Illinois, an unsecured creditor becomes a lien creditor against property at the end stage of the judgment process. Thus, in Illinois, an unsecured creditor becomes a "lien creditor", (a) with respect to borrower's real estate located in Illinois, on the date a transcript, certified copy or memorandum of judgment is recorded in the county where the real estate is located, and (b) with respect to borrower's personal property located in Illinois, (i) on the date a certified copy of the judgment is delivered to the sheriff or other proper officer to be served for execution, or (ii) in the case of a citation to discover assets, when the citation is served on the borrower.

Under UCC Section 9-323, (a) an unsecured creditor who becomes a lien creditor of the borrower <u>prior</u> to the lender's perfection of its security interest will have priority over the lender, and (b) an unsecured creditor who becomes a lien creditor of the borrower <u>after</u> the lender perfects its security interest will prime a lender's future advances made more than 45 days after the creditor became a lien creditor unless, (i) the lender's advance is made without knowledge of the lien, or (ii) the lender's advance was made "pursuant to a commitment entered into without knowledge of the lien".

4. <u>Constructive Fraudulent Transfers</u>. A guaranty or a grant of a security interest or lien in personal property or real property by a guarantor or any other non-borrower (each hereafter called a "Transferor") can be challenged by another creditor or other third party as a constructive fraudulent transfer if as a result of the guaranty or grant of a security interest or lien, the Transferor, as the case may be, (A) (i) was rendered insolvent or nearly insolvent as a result of giving such guaranty or granting such security interest or lien, or (ii) was left with unreasonably small capital, or (iii) did not expect or intend to have the ability to pay its debts as they became due, and (B) did not receive "reasonably equivalent value" in exchange for such guaranty or grant of security interest or lien. For a constructive fraudulent transfer challenge to be successful, both of the conditions in subsections (A) and (B) above must be met.

The term "reasonably equivalent value" means far more than nominal consideration required to sustain a contract. In order to find that a Transferor received "reasonably equivalent value" in exchange for the guaranty, security agreement, mortgage or other transfer, many courts require that the Transferor receive a "direct" benefit in exchange for the transfer by receiving a direct economic benefit from the loan transaction. Other courts have adopted a more modern approach and have held that a Transferor received "reasonably equivalent value" if it received an "indirect benefit" for the transfer. In determining whether the Transferor received "reasonably equivalent value" in these indirect benefit cases, a number of courts have focused on whether the value of the "indirect benefit" received by the Transferor was "reasonably equivalent" to the property transferred by the Transferor.

Examples of "indirect benefits" that in some cases have saved a transfer from a fraudulent transfer challenge include, (i) the increased ability of the borrower to obtain working capital that benefitted the entire corporate group, (ii) the borrower and the Transferor were so related or situated that they shared an "identity of interests", and as a result the Transferor received a sufficient "indirect benefit" for the transfer, and (iii) the borrower was able to retain an important source of supply or an important customer or enter into a new market.

Unfortunately, there is no "bright line" test established by the courts to assess whether a Transferor has received a sufficient "indirect benefit" to support a transfer and the lack of such test poses a business risk for lenders who may ultimately need to prove in a court that such "indirect benefit" was received by the Transferor in order to thwart a fraudulent transfer challenge in a bankruptcy or other proceeding.

The risk of a fraudulent transfer challenge is almost always present with respect to intercorporate guaranties, security agreements and mortgages where the Transferor is a subsidiary or affiliate of the borrower or has no relationship to the borrower. Such risk is always present if the Transferor is an entity (such as a corporation, partnership or limited liability company) guaranteeing the debt of an individual.

In addition, a potential constructive fraudulent transfer risk is also present, and an analysis warranted, (i) in a leveraged stock acquisition since all, or the bulk, of the loan proceeds are paid to the selling shareholders instead of the borrower, (ii) in a leveraged asset acquisition, if the structure is such that the conditions set forth in both subsections (A) and (B) of the first paragraph above are both met, (iii) in loan transactions where the loan proceeds are payable to one or more affiliates or subsidiaries of the borrower, and (iv) when co-borrowing entities obtain a loan, and one or more of the entities encumbering its assets (typically, the entity with the majority of the assets) may not receive "reasonably equivalent value" from the loan in exchange for such grant of security interest in or lien on its assets.

A downstream guaranty (parent guarantees subsidiary) is generally believed to be insulated from a "constructive" fraudulent transfer attack provided that the subsidiary itself was not insolvent or nearly insolvent at the time of the loan, on the theory that the parent is ultimately benefiting from the loan made to its wholly-owned subsidiary. However, when the parent owns less than 100% of the subsidiary, the purported benefit of the loan to the parent may be diminished depending on the percentage of the parent's ownership of the subsidiary.

5. <u>Landlord's Liens</u>. Under existing Illinois case law, a landlord in Illinois can obtain a lien against the property of its tenant, upon a tenant's default, only after the landlord has seized the tenant's property and filed a distress warrant with the clerk of the circuit court (together with an inventory of the property seized) pursuant to 735 ILCS 5/9-301. The landlord's lien can only prime a lender's lien if the landlord has seized the tenant's property and filed its distress warrant <u>before</u> the lender has perfected its security interest. A landlord can also obtain a written grant of security interest in the tenant's property, but in such event it must file a UCC financing statement just like any other secured party (and in such case, the landlord's priority will be based on the UCC's "first-to-file-or-perfect" rule). It should be noted that in some other states, a landlord's lien may, by statute or case law, prime a lender's earlier perfected security interest. Most landlord waivers used by lenders either require the landlord to waive its lien rights or subordinate them to the lender's security interest in the tenant's property.

6. <u>State Possessory Lien Statutes</u>. By statute or common law in many states, a person in possession of goods (which is subject to an existing security interest) who furnishes services or materials with respect to such goods in the ordinary course of such person's business, will obtain a lien that takes priority over an earlier perfected security interest in such goods (except as set forth in the following paragraph). Examples include a repairmen's lien, artisan's lien, mechanic's lien and warehouseman's lien. UCC Section 9-333 recognizes the priority of these liens for services or materials. Many lenders dealing with inventory at warehouses or third-party processors require the warehouse or processor to sign a bailee agreement recognizing the lender's senior security interest in the inventory and waiving any rights to claim a lien in the inventory, provided the bailee's customary fees and charges are paid.

However, it should not be assumed that every possessory lien will prime an earlier perfected security interest in the goods. UCC Section 9-333(b) provides that a possessory lien on goods has priority over a security interest in the goods unless the lien is created by a statute and such statute gives priority to the security interest.

7. <u>Surety's Right of Subrogation</u>. Lenders financing a building contractor or subcontractor must be aware that a surety company who issues a payment and/or performance bond for such contractor or subcontractor, and either makes payments under such bond or completes the bonded job upon default by the contractor or subcontractor, will be given priority over the lender in all retainage funds held by the developer or owner for such job. The surety will be given priority over the lender in such retainage funds even though, (i) the lender has a first priority perfected security interest in all assets of the contractor or subcontractor (or in all of the contractor's or subcontract's accounts or in the specific contract), (ii) the surety does not file a UCC financing statement, and (iii) the surety's bonds are executed after the lender filed its UCC financing statement. The lender loses such a priority dispute to the surety because such dispute is not governed by the priority rules of Article 9 of the UCC. Article 9-109 of the UCC provides that the scope of Article 9 extends only to a transaction "that creates a security interest in personal property or fixtures by contract." The surety's rights in the retainage funds arise by operation of law under the equitable doctrine of subrogation. Such rights of the surety are not deemed to be a "security interest in personal property created by contract."

8. Federal Assignment of Claims Act. A lender obtaining a security interest in a federal contract who fails to comply with the Federal Assignment of Claims Act ("FACA"), 31 U.S.C. §3727, will still be deemed to have perfected its security interest so long as it has filed an appropriate UCC financing statement (and of course, has an adequate security agreement in place). However, the failure to comply with FACA means that the federal government will not recognize the lender's assignment of the contract and the lender must look to the borrower (or its trustee in bankruptcy) to recover the proceeds.

If the federal contract states it is not assignable, then the lender cannot obtain an assignment of the contract, but could obtain a security interest in the account generated by the sale of goods or performance of services thereunder. It is always advisable to review the contract, the particular federal agency rules regarding contract assignment requirements and to contact the agency's legal department to confirm all aspects of the assignment process.

9. Perishable Agricultural Commodities Act ("PACA"). Under the federal Perishable Agricultural Commodities Act ("PACA"), 7 U.S.C. §499, et seq., a statutory "floating" trust is created for unpaid sellers of perishable agricultural commodities (fresh and frozen fruits and vegetables) by which a buyer's obligation becomes a trust obligation superior to the interest of a secured lender. Perishable commodities sold pursuant to PACA are to be held in trust for the benefit of all unpaid (cash or credit) suppliers or sellers until full payment of the sums owing to such suppliers or sellers have been received. The term "seller" is very broad and includes farmers and all other parties in the chain of distribution. In effect, PACA gives qualifying trade creditors a priority ahead of the secured lender, and for this reason, conventional accounts receivable and inventory financing is not readily available for brokers, commission merchants and dealers who purchase perishable agricultural commodities. If a lender wants to make a loan which may involve a PACA trust, the lender should consult with an attorney who specializes in PACA since this is a highly specialized area of law.

10. Packers and Stockyards Act. Under the federal Packers and Stockyards Act of 1921, 7 U.S.C. §181, et seq. ("PSA"), a packer whose average annual purchases of livestock exceed $500,000, is deemed to hold all livestock purchased in cash transactions (including all products and proceeds thereof) in trust for the benefit of the cash seller until the seller receives full payment. As a result, all accounts and inventory of a qualified packer that are traceable to livestock purchased from unpaid cash sellers are subject to the superior claim of the unpaid cash sellers. A key issue for a lender financing a borrower in the livestock business is to confirm that the proposed borrower does not qualify as a "packer" under the PSA. A "packer" is defined under the PSA as "any person engaged in the business, (a) of buying livestock in commerce for purposes of slaughter, or (b) of manufacturing or preparing meats or meat food products for sale or shipment in commerce, or (c) of marketing meats, meat food products, or livestock products in an unmanufactured form acting as a wholesale broker, dealer, or distributor in commerce." There is existing case law interpreting this definition of "packer" which in certain instances may need to be examined on a case-by-case basis.

11. Poultry Producers Financial Protection Act. Under the federal Poultry Producers Financial Protection Act of 1987, 7 U.S.C. §197, 2286 et seq., poultry obtained by a live poultry dealer (including all inventory of, or proceeds from, such poultry), are subject to a trust similar to that created by the PSA. The trust protects both unpaid cash sellers and owners of poultry who contract for "grow-out" services, and applies to live poultry dealers whose average annual sales, or average annual value of live poultry obtained by purchase or poultry growing arrangements, exceed $100,000.

12. <u>"Hot Goods" provision of the Fair Labor Standards Act</u>. The federal Fair Labor Standards Act (the "FLSA"), 29 U.S.C. §201, et seq., provides that the Secretary of Labor can enjoin the sale of goods in interstate commerce if the minimum wages required to be paid under the FLSA have not been paid. In <u>Citicorp Industrial Credit, Inc. v. Brock</u>, 107 S. Ct. 2694 (1987), the U.S. Supreme Court held that a secured creditor seeking to hold a foreclosure sale of inventory manufactured in violation of the minimum wage or overtime provisions of the FLSA may be enjoined by the Department of Labor. The effect of this Supreme Court ruling is that tainted inventory (i.e., inventory manufactured in violation of the FLSA) cannot be sold at foreclosure unless the proceeds (or some other funds) are used to pay the aggrieved employees the accrued wages due them. In <u>Reich v. Midwest Body Corporation</u>, 843 F. Supp. 1249 (N.D. IL 1994), the court held that the lender must pay the employees "straight time and overtime based on their contract rates, not based on minimum wage rates, in order to satisfy the obligations it undertook in order to sell goods that would otherwise be 'hot goods'."

13. <u>True Lease vs. Lease Intended As Security</u>. A lender who finances an equipment lease and files a UCC filing only against the lessor, and not the lessee, will be deemed to have an unperfected security interest in the equipment should the lease later be determined by a court to be a lease "intended as security" rather than a "true" lease (since in such instance, the lessee is deemed the owner of the equipment). For this reason, it is customary in equipment lease financing transactions to require, in addition to the lender's UCC filing against the lessor, that a precautionary UCC filing be made by the lessor against the lessee covering the leased equipment, and that such filing be assigned to the lender.

14. <u>Assignment of a Single Account, Payment Intangible or Promissory Note for Preexisting Indebtedness</u>. Under UCC Section 9-109(d)(7), an assignment of a single account, payment intangible or promissory note to an assignee in full or partial satisfaction of a preexisting indebtedness is excluded from Article 9, meaning that a qualified assignee need not file a UCC financing statement against the assignor of such single account, payment intangible, or promissory note, which means that such assignment will not be reflected in a UCC search on the borrower. The Official Comment to 9-109 indicates that such isolated assignments were excluded from Article 9 because they do not, by their nature, concern commercial financing transactions. However, see the 1977 case cited below for the impact of an isolated assignment on a secured lender.

15. <u>Assignment of Insignificant Part of Outstanding Accounts or Payment Intangibles</u>. A similarly troubling provision is UCC Section 9-309(2) which provides that no UCC financing statement needs to be filed to perfect "an assignment of accounts or payment intangibles which does not by itself or in conjunction with other assignments to the same assignee transfer a significant part of the assignor's outstanding accounts or payment intangibles." In a leading case, <u>Architectural Woods, Inc. v. State of Washington</u>, 562 P2d 248, 21 UCC Rep. 1181 (Wash. 1977), the non-filing assignee was the first to obtain an assignment of a $100,000 contract owed by the State of Washington. A lender took a subsequent assignment and did file a financing statement. The court gave priority to the first assignee who did not file under the "first to file or perfect" rule on the basis that the first assignee did not need to file under former UCC Section 9-302(1)(e). The court construed the words "significant part of the outstanding accounts or contract rights of the assignor" by using a "casual or isolated" test. Since the assignment was an isolated transaction, it was automatically perfected without filing, despite the fact that the contract amount in fact constituted a substantial percentage of the assignor's aggregate contract rights. Some courts rely on the "casual or isolated" test described above, while others look at the percentage of accounts involved in the assignment in determining whether it constitutes a "significant part of the outstanding accounts of the assignor."

16. Sale of Accounts and Chattel Paper. Even though a transaction is structured as a sale of accounts or chattel paper, UCC Section 9-109(a)(3) provides that Article 9 applies to such sale, and as a result, the purchaser must file a UCC financing statement against the seller of the accounts or chattel paper being purchased. Failure to file a UCC financing statement against the seller is fatal as against third parties dealing with the seller, such as subsequent lien creditors, perfected secured parties, qualified buyers, and the seller's trustee in bankruptcy.

17. Sale of the Collateral. Under UCC Section 9-315(a), a security interest continues in the collateral notwithstanding sale, exchange, lease, license or other disposition unless the disposition was authorized by the secured party "free of the security interest" in the security agreement or otherwise. There are certain exceptions to this general rule, including, without limitation, exceptions for buyers of inventory from dealers in the ordinary course of business, buyers of consumer goods under limited circumstances and qualified buyers of chattel paper or instruments. Other than these and other designated exceptions, the UCC places the burden on secured parties to trace the ownership of the collateral back to its origin and to search all parties in the chain of title. For example, notwithstanding a lender's first priority perfected security interest in all present and future equipment owned by ABC Corp., if ABC Corp. acquired equipment from XYZ Corp. but did not know about or otherwise take action to remove a previously filed UCC statement filed against XYZ Corp. by another creditor against the equipment (and such creditor's indebtedness was not paid off or discharged), such creditor's security interest will continue in the equipment and will prime the security interest held by ABC Corp.'s lender (subject to certain potential limitations described in UCC Sections 9-316 and 9-507).

18. Debtor's Name Change. Under UCC Section 9-507(c), if a debtor changes it name so that the existing UCC financing statement becomes seriously misleading, there must be an amendment to such UCC financing statement filed within 4 months of the name change, with respect to collateral acquired more than 4 months after the name change. The secured party is protected as to collateral owned by the debtor prior to the name change and also as to collateral acquired within 4 months of the name change. In conducting due diligence on a prospective debtor, the UCC places the burden on the secured party to search the debtor's former names to determine whether there are any existing UCC filings against the debtor's assets which could be protected under this 4-month rule. In addition, the 4-month rule obligates a lender to monitor changes in its debtor's name and to amend its existing UCC filing within the 4-month period in order to remain perfected in collateral acquired more than 4-months after the name change.

19. Purchase-Money Security Interests. Lenders holding a prior perfected security interest in all present and future business assets of a borrower can be primed as to certain future assets of a borrower financed by third parties under various purchase-money rules under the UCC. Three of these important purchase money rules are described below:

First, it is important to distinguish between "equipment" and "inventory" under the UCC since there is sometimes confusion regarding when items of equipment are classified as "inventory" under the UCC (and such classification becomes important for purchase-money rules and for other reasons). "Equipment" under the UCC means goods other than inventory, farm products or consumer goods that are used in the borrower's business (such as a printing press, computer system, machine tools, etc.). "Inventory" under the UCC means goods held for sale or lease, or which are leased by the borrower or are to be furnished under a contact of service. Thus, equipment owned by a leasing company held for sale or lease or that is otherwise being leased by the leasing company is classified as the leasing company's "inventory" under the UCC.

a. **Purchase-Money Security Interest in Equipment.** A purchase-money secured party who finances specific equipment for a borrower (or in the case of a seller, retains a security interest in the equipment sold to secure all or part of its price), will prime an earlier perfected blanket security interest in the borrower's equipment, if such purchase money secured party files its UCC financing statement against the borrower covering the specific equipment being acquired by the borrower, within twenty (20) days after the borrower receives possession of such equipment.

Lenders should be aware that under UCC Section 9-324(g), if there is more than one security interest that qualifies as a "purchase money security interest", the "vendor's PMSI" has priority over a "lender's PMSI", and for that reason, the best practice in equipment financing is for a lender to pay the vendor directly or confirm that the vendor has been paid in full prior to disbursing the loan to the borrower. This same priority rule also applies to purchase money priority rules for inventory and other collateral.

b. **Purchase-Money Security Interest In Inventory.** A purchase-money secured party who finances inventory for a borrower (or in the case of a seller, retains a security interest in inventory sold to secure all or part of its price), will prime an earlier perfected blanket security interest in the borrower's inventory, if each of the following conditions are met, (i) the purchase-money security interest is perfected when the borrower receives possession of the inventory, (ii) the purchase-money secured party sends an authenticated (written) notice to the holder of each conflicting security interest stating that the purchase-money secured party has or expects to acquire a purchase-money security interest in inventory of the borrower and describes the inventory, and (iii) the holder of the conflicting security interest receives the notice within five years before the borrower receives possession of the inventory (which means such notice must be repeated every five years).

c. **Purchase-Money Security interest in Chattel Paper.** A purchase-money lender or purchaser who gives "new value" to a lessor and take possession of the original chattel paper, will prime an earlier perfected UCC filing covering the chattel paper. These purchase money rules present a significant risk for lenders who finance leases but do not take possession of the original leases.

First, UCC Section 9-330(a) sets forth a purchase money priority rule for chattel paper claimed merely as proceeds of inventory. Under this Section, a qualified lender or purchaser can prime an earlier UCC filing covering all inventory of a debtor and proceeds of such inventory including chattel paper, if the new lender or purchaser, in good faith in the ordinary course of its business, gives new value (i.e., loan money) and takes possession of the original chattel paper.

Second, UCC Section 9-330(b) sets forth a purchase money priority rule for chattel paper not claimed merely as proceeds. Under this Section, a qualified lender or purchaser can prime an earlier UCC filing which covers the lease(s), if the new lender or purchaser, in good faith in the ordinary course of its business, gives new value (i.e., loan money), takes possession of the original chattel paper, and has no knowledge that the purchase or loan violates the rights of the secured party.

In some situations, it is not feasible for a lender financing leases to take possession of the original leases. For example, there may be thousands of original small-dollar leases. Under the UCC, the lender may consider stamping each original lease with a conspicuous legend on the face page of each lease, such as "This Lease has been assigned to ABC Bank, 123 Central Avenue, Chicago, IL 60603". This legend is designed to put any potential lender or purchaser on notice that the leases have been assigned and to block the ability of such lender or purchaser to qualify for purchase money priority (although such legending would need to be monitored and could be easily removed by an unscrupulous borrower, presenting a potential significant business risk to the lender). Wherever possible, the best protection is to take possession of the original leases.

20. <u>Pledged Deposit Account Maintained At Another Financial Institution</u>. Many lenders obtain control of a pledged deposit account at another financial institution by entering into a three-party control agreement with the depository bank and the pledgor. Unless the control agreement contains the depository bank's subordination of its security interest in the deposit account to the lender's security interest in the deposit account, the depository bank's security interest in such pledged deposit account will have priority over the lender's security interest therein. Many lenders are not aware that a depository bank has an automatic first priority security interest in the pledged deposit account by statute (UCC Section 9-327) and for this reason, such subordination is needed in the control agreement.

21. <u>Pledged Securities Account Maintained At A Brokerage House or Another Financial Institution</u>. Many lenders obtain control of a pledged securities account at a brokerage house or another financial institution by entering into a three-party control agreement with the securities intermediary and the pledgor. Unless the control agreement contains the security intermediary's subordination of its security interest in the securities account to the lender's security interest in the securities account, the securities intermediary's security interest in such pledged securities account will have priority over the lender's security interest therein. Many lenders are not aware that a securities intermediary has an automatic first priority security interest in the pledged securities account by statute (UCC Section 9-328) and for this reason, such subordination is needed in the control agreement.

22. <u>Late Perfection</u>. Another landmine for lenders is the risk that its security interest or lien in the borrower's collateral will be challenged as a voidable preference in a subsequent bankruptcy of the borrower if, (i) the date of perfection of such security interest or lien was not achieved within ten (10) days after the loan disbursement, and (ii) the debtor files bankruptcy within 90 days after the date such late perfection occurred. For this reason, it is imperative that the lender's UCC financing statement or recorded mortgages be on file within ten (10) days of loan disbursement. Wherever feasible, having the borrower authorize the lender in writing to pre-file the UCC financing statement(s) prior to loan closing will eliminate the risk of late perfection. Also, the availability of electronic filing of UCC financing statements in many states has helped eliminate a possible late filing. For real estate closings, lenders should include in their money lender's escrow agreements or instructions, the title company's agreement that it will record the mortgage and any other recordings within ten (10) days of the escrow disbursement. Remember that the title companies stopped issuing the "creditor's rights" endorsement a number of years ago, so that even if the mortgage or other recordings are recorded more than 10 days after escrow disbursement, the title company can deny a claim by the lender if the mortgage is set aside as a "voidable preference" due to the late filing of the mortgage and a bankruptcy of the mortgagor within said 90-day period.

23. Liens Affecting Real Estate:

a. Mechanic's Liens. Under the Illinois Mechanics Lien Act, 770 ILCS 60/1 et seq., a person who furnishes labor, material, fixtures, apparatus, machinery or certain services in connection with the construction of improvements on real property, and timely records a mechanic's lien claim against the real property, is granted a lien on the real property for payment. A mechanic's lien properly recorded against mortgaged real property will prime a prior recorded mortgage to the extent the mechanic can prove that the unpaid work or services improved the value of the real property.

It should be noted that a loan policy issued by a title insurer insuring the lender's mortgage does not insure the lender against a subsequent recorded mechanic's lien unless the construction was financed by the proceeds of the insured mortgage and the title insurer (via a construction escrow agreement) examined and approved the sworn owner's and contractor's statements and partial or final lien waivers for each requested draw, and issued the lender date down endorsements to the loan policy increasing the policy coverage by the amount of each approved construction advance.

b. Real Estate Tax Liens and Assessments. In Illinois, a real estate tax lien or assessment against the mortgaged property (including, all penalties, interests and costs that may accrue thereon) will also prime a prior recorded mortgage, and if the taxes are sold and are not redeemed by the mortgagor within the applicable statutory period, a tax deed will be issued which, if timely recorded, will wipe out all existing mortgages and other encumbrances on the property. To manage such potential risks, lenders frequently take one of the following actions for mortgaged real estate: (i) require the borrower to maintain a real estate tax escrow with the lender, with lender paying or administering payment of the real estate taxes, (ii) retain a real estate tax reporting service to monitor and confirm timely payment of periodic real estate taxes, (iii) require the mortgagor to promptly provide the lender with evidence of payment of the taxes within a short period following the due date, or (iv) obtain periodic tract book searches which include a tax search of the property.

c. Demolition Liens. Under Illinois statute (65 ILCS 5/11-31-1), the costs incurred by a municipality in the repair or demolition of a building constitutes a lien on the real property, and this lien will prime the lien of a prior recorded mortgage, if it is recorded within 180 days after the completion of the demolition work.

This article is informational in nature and is not intended to constitute, nor should it be relied upon as, legal advice to any recipient. Please contact us for an analysis of any of these liens or interests as they may apply to your circumstances.

Bennett L. Cohen, Esq.

About the Author

Bennett L. Cohen is a partner in the law firm of Cohen, Salk & Huvard, P.C. Bennett concentrates his entire practice in commercial finance. He regularly represents banks, commercial finance companies and other institutional lenders in the structuring, documentation and closing of commercial financing transactions, including asset-based loans, commercial & industrial loans, commercial real estate mortgage and construction loans, equipment lease loans and factoring transactions. He served for fifteen years as general counsel to the Midwest Association of Secured Lenders, a trade association of over eighty banks and finance companies located in Chicago and outlying areas. Bennett is a member of the American Bar Association and serves on the ABA Committee on Commercial Financial Services and the ABA Subcommittees on Secured Lending, Loan Documentation and the Uniform Commercial Code. He is a member of the ABA Task Force on Forms under Article 9. He was a member of the ABA Joint Task Force on Deposit Account Control Agreements, the ABA Model Intercreditor Task Force, and the ABA Joint Task Force on Filing Operations and Search Logic.