

Spearing Tool and Manufacturing, Inc.

IRS Lien Valid Over Lender's "Properly Perfected" Security Interest

Points to the Lender's Need for Greater Article 9 Protection

By Theodore H. Sprink

A protracted dispute with the internal Revenue Service is something that most of us would agree is to be avoided. The time and expense required to resolve such disputes can adversely affect business owners, employees, customers, creditors and outside counsel. The "Spearing Tool" case demonstrates that even "secured" creditors, can suffer significant financial loss exposure when a security interest is found to be absent, defective, subject to search inaccuracies, improperly filed or simply determined to be in a priority position subordinate to expectations.

In summary, Spearing Tool and Manufacturing Co., Inc. entered into a series of secured financing arrangements with its lender commencing in 1998 and 2001. Spearing granted its lender a security interest in all its assets, with the lender perfecting its security interest by filing a UCC financing statement using the borrower's precise and exact corporate name as registered with the appropriate Secretary of State's office.

During the course of the financial relationship between Spearing and its lender, Spearing fell behind on its federal employment tax payment obligations, and the Internal Revenue Service filed two Notices of Federal Tax Lien against Spearing in the appropriate jurisdiction. However, the liens identified the debtor as "Spearing Tool & MFG. Company Inc.", a slight variation from the actual and formal registered corporate name. This variation is the name Spearing used on some, but not all of its tax return filings. In other filings it used yet another variation that differed from the name which granted the lender a security interest in its assets.

The validity and enforceability of the lender's security interest, and the contest for perfection and priority, involved the District Court, the 6th Circuit Court and the U.S. Bankruptcy court. The bank claimed to be in the first priority position by virtue of the "precision" of its filings and their prevailing date(s). The IRS claimed its liens to basically be "close enough" without incurring the undue burden of "absolute precision" and unwieldy reliance on varying "search logics"

with respect to its searching and filing of the appropriate UCC records. At the end of the day, the court found the IRS exempt from UCC requirements, the very “search and filing” basis upon which much of the nation’s secured Article 9 lending takes place.

In recent years the title insurance industry has provided the real estate and commercial finance markets an important new product that for the first time insures the lender’s security interest in Article 9 collateral for validity, enforceability, attachment, perfection and priority. So-called “UCC insurance” includes UCC search and filing functions, covers the “Gap” lending period, and provides for “cost of defense” in the event a lender’s security interest is challenged.

Although basic UCC insurance policy coverage furnished by Fortune 500 title insurance companies will not provide full protection from Federal and State tax liens, the lesson for secured lenders is clear: be very, very precise, or risk being unsecured.

As commercial lending is more and more exposed to what many anticipate as a downturn in the economy, and as credit grows tighter and default rates rise, proper perfection and priority of the lender’s security interest in “reliance collateral” will become crucial in loan underwriting, particularly in major-market segments. Lenders are likely to find relying on the legal opinion of outside counsel as problematic as relying on the variations and un-precise pitfalls of UCC lending.

The new UCC insurance available from leading title insurance companies provides an outstanding alternative, an attractive outsource and a simple way to enhance the credit underwriting process for commercial lenders.

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