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AVOIDING SUPER-PRIORITY LIENS IN ACCOUNTS RECEIVABLE FINANCING

by Thomas E. McCurnin

The scene is a common one. The accounts receivable lender's borrower has performed satisfactorily for the past few years. But, unknown to the lender, something is amiss. The borrower has failed to make payments to creditors, including the IRS; is behind to the union trust fund; and has failed to pay some key trade creditors for agricultural goods. The lender has not conducted an audit for about a year, and even if it had, the lender has perfected security interest which it believes will protect fully against other creditors.

Unfortunately, the lender is mistaken. All have the right to some or all of the lender's receivables, despite the prior filed security interest.

These "secret" liens have the potential of stripping the lender's collateral, without notice to the lender by the intervening trade creditor. Knowledge of these liens can be of great value to the secured lender in documentation, liquidation and litigation.

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The IRS super-priority lien

The most common of these super-priority liens is the tax lien under Section 6323 of the Internal Revenue Code, which arises when the taxpayer fails to pay a tax after assessment and demand. This lien will gain super-priority status on all assets of the taxpayer 45 days after filing and service of the lien on the taxpayer. There is no requirement that the lien be served on the secured lender.

The statute giving rise to the tax lien does not contain any provisions as to priority. Instead, its super-priority status is based on the "choateness doctrine," which developed in a series of United States Supreme Court cases that upheld the priority of federal tax liens.[1] The choateness doctrine provides that a prior perfected security interest has priority over a later-filed tax lien only if, at the time the tax lien was filed, the secured lender's lien was "choate." A secured lender's lien on accounts receivable is "choate" only if the lender has advanced sums to the debtor, has perfected its security interest, and the specific account receivable in question existed at the time the court measured priority, which is 45 days after the date on which the tax lien was filed and served.[2] In short, accounts receivable generated 45 days after the lien filing are not choate. In order to have priority, the lender with a security interest in accounts receivable must be able to point to an assigned invoice which was in existence within 45 days after the tax lien was filed and served.

There are few defenses to the super-priority lien of the IRS, because the lien essentially terminates a debtor's interest in all property, including receivables. Lenders have asserted two main defenses in the lien statute to the IRS super-priority lien: the "statutory commercial financing" and the "purchase money" exceptions. Neither defense has proven successful.

The "commercial finance exception" provides that an IRS super-priority lien will not be valid as against a security interest created by a "commercial financing agreement in the ordinary course of the taxpayer's business," if the security interest was acquired before the 46th day after the filing of the lien. Secured lenders have argued that the filing of a UCC-1 before the filing of the IRS lien, which perfected the security interest in receivables, constitutes the acquisition of a prior security interest and that it was the intent of Congress to exempt commercial financing agreements from the 1966 amendments to the IRS Code. Notwithstanding this exception, the courts still use the choateness doctrine to rule that accounts in which the lender claims a prior interest must nevertheless be in existence within the 45-day time window. Thus, any invoice generated after this time period, even though subject to a security agreement and a financing statement, will belong to the IRS.

The statutory purchase money security interest exception is applicable where a borrower purchases equipment financed by a secured lender before the expiration of the 45-day time window. It seems clear that this would not involve receivable financing, although several lenders have

attempted to argue that assignment of specific invoices constitutes a purchase money security interest. All of them have failed.[3]

Another important issue is the extent to which the super-priority IRS lien attaches to the borrower's bank account. Because the IRS lien attaches to all the borrower's property, absent a perfected security interest, the IRS will have priority over the bank account. However, the amount in the borrower's checking account, if properly pledged to the lender and perfected before the expiration of the 45-day time window, should be considered choate, and not subject to the federal lien, and therefore should be a safe harbor for secured lenders.[4]

Super-priority tax liens remain a powerful weapon in the hands of the IRS. However, secured lenders may protect themselves from application of the lien statute by following some of the guidelines set forth at the end of this article, by cooperating with the IRS and, if demanded, turning over (or at least interpleading) any disputed funds. Indeed, the failure to turn over the funds in which the IRS claims an interest may subject the lender to severe sanctions, including a 50 percent penalty of the sums withheld.

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The federal insolvency statute

The second government statute affecting receivable financing is not a lien, but an order of distribution which gives priority to government claims. Known as the "federal insolvency statute," this act imposes a specific order of distribution whenever money is owed to the government or any government agency.[5] Specifically, the statute requires that all government claims be paid ahead of all other creditors, (including secured lenders), when two elements exist — a government claim and a defined act of insolvency by the debtor. For purposes of the statute, an act of insolvency is defined as the appointment of a receiver over any asset, the assignment for the benefit of the creditors of the borrower, a fraudulent transfer, or having liabilities exceed assets. Interestingly, insolvency does not include a bankruptcy filing, where priority is governed by general bankruptcy laws.[6]

The typical example would involve a borrower which has assigned its receivables to a secured lender, and the borrower has also obtained a loan from the SBA. The borrower defaults on its loan to the secured lender, and the secured lender files suit, seeking the appointment of a receiver to collect the receivables. Under the statute, an act of insolvency has occurred, and the SBA may intervene, remove to federal court, and seek an order compelling the receiver to pay the SBA any receivables generated after the appointment of the receiver.

The effect: the government has a priority claim to the receivables generated after the act of insolvency. This statute does not create a lien; however, there is little practical distinction between the two, as the statute subordinates secured lenders. The government will be paid first from the property subject to the statute. This "lien" may be imposed on all debtor property including property transferred to assignees and real estate. All state-law liens yield to this statute unless the liens are "choate," which is defined in a similar manner as the cases interpreting IRS liens.

Triggered only by an act of insolvency and governed by the same principles of choateness, the statute is a bit easier for the secured lender to avoid application than the IRS lien. First, accounts receivable lenders should avoid seeking a receiver. This is considered an act of insolvency and would trigger application of the statute unless the receivables generated before the act of insolvency more than cover the loan. Second, because the act does not apply to "choate" liens, it would not affect perfected security interests in equipment or a mortgage on real property. Future accounts receivable after the act of insolvency would be subject to the interest of the government.

Pension priority claims

Many borrowers who operate union shops are required to make contributions to an ERISA union trust fund. In the event that the borrower fails to pay the contribution to the trust fund, ERISA provides for a super-priority lien in favor of the trust fund.[7]

This lien enjoys the same priority as the IRS super-priority liens. Indeed, the ERISA statute incorporates by reference Section 6323 of the IRS Code. This lien covers all property of the borrower and subordinates all other liens, except those which are choate. It is even applicable in a bankruptcy proceeding. This lien arises after the trust has audited the borrower, determined there is a default, and made demand on the borrower. It is enforced by the trust fund by a federal lawsuit.

Agricultural super-priority liens

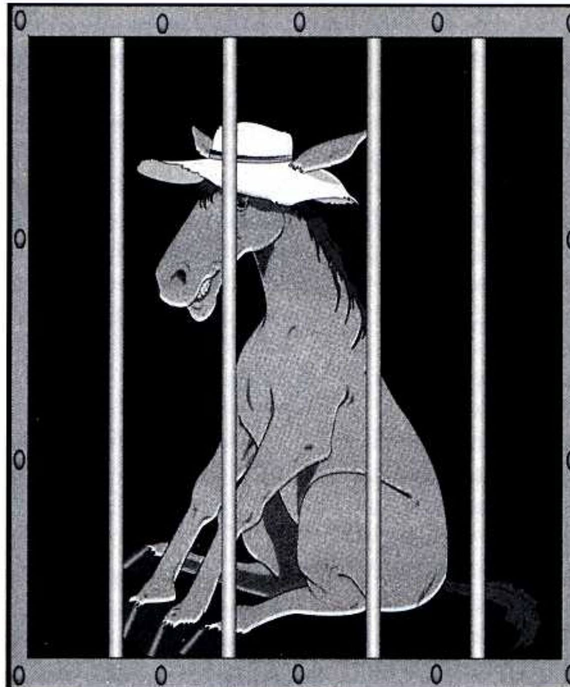
Secured lenders financing certain types of agricultural, livestock, or poultry dealers should be aware that there are three main sources of super-priority liens directly affecting

these industries. All three can subordinate the lender financing receivables. The three acts are the Perishable Agricultural Commodity Act, the Packers and Stockyard Act and the Poultry Producer Financial Protection Act.

Each imposes a super-priority lien in favor of the trade creditors of dealers of fruits and vegetables, livestock producers and poultry dealers. The Perishable Agricultural Commodity Act, (PACA) grants a super-priority lien status in favor of trade creditors who supply perishable agricultural commodities to dealers of fruits and vegetables.[8] This statute imposes a trust fund on all assets of the borrower which has purchased fruit and vegetables from any supplier and has failed to pay for them within 30 days after receiving the goods and receiving proper notice under the act.

Even if "choate,"[9] this lien primes a prior secured lender on receivables, on its commodity inventory collateral and noncommodity inventory if the proceeds were commingled, and on previously made payments to the lender if the lender had actual knowledge of the existence of the PACA trust, such as reviewing the invoices with the statutory notice, at the time that the payments were received. Finally, the lien can prime funds in a checking account, if the bank had knowledge of the PACA Trust.

The Packers and Stockyard Act imposes a trust in favor of its suppliers on the assets of a livestock packer, which may spring into a super-priority lien when a packer fails to pay for livestock, such as cattle, sheep, or horses.[10] The act has identical notice provisions to PACA and has spawned identical case law concerning the nature of the lien and the lien's priority as against receivables and other property of the packer. The only significant difference: the packer must have annual purchases of over $500,000 to fall within the provisions of the act.



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The Poultry Producer Financial Protection Act is also identical to PACA as to the nature of the lien, the lien's priority and its effect on property of the dealer.[11] It has a lower floor of $100,000 in annual purchases.

Lenders have few defenses to claims under PACA or its progeny. In a typical example, a secured lender finances receivables in a PACA-controlled industry. If the borrower fails to pay its suppliers, these PACA trade creditors may sue and seek the appointment of a receiver, which will collect the receivables for the benefit of the trade creditors. The secured lender will be primed, to the extent of the amount of all PACA trade accounts.

Because PACA is dependent on the prompt notices by the trade creditors, lenders may be able to defeat PACA claims based on an untimely notice. The lender can also argue that the account debtor was not within the class of dealers as defined in the statute. PACA will only apply if the borrower's customer is a defined dealer. A dealer is defined as a person who purchases the agricultural goods solely for sale at retail, and purchases in excess of either $230,000 (PACA), $500,00 (Packers and Stockyards Act), or $100,000 (Poultry Producer Protection Act) in perishable agriculture goods per calendar year. The courts have been quite generous in interpreting this definition, and in a recent case, a restaurant was held to be a dealer of agricultural goods.[12]

Equipment is exempt if the lender received the loan payments without notice of the PACA trust, as a "bona fide purchaser for value," which is a defense under PACA case law. However, the borrower's bank account, and even loan payments made to the lender, may be recovered by the PACA trade creditors, unless the lender can show that the funds came from non-PACA sources such as another industry or product line not covered by PACA.*

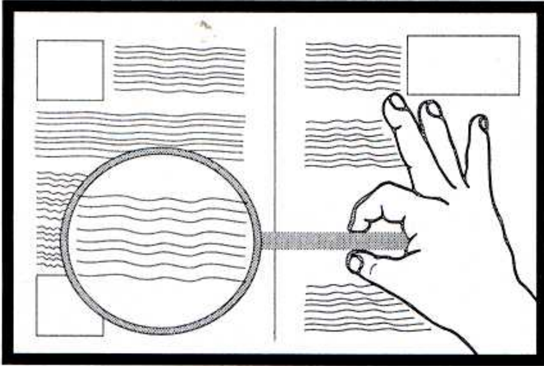
Other priority liens

The secured lender financing receivables also risks losing its priority under the doctrine of equitable subordination, where another creditor has expended effort in storing or improving collateral. In the typical example, a farmer pledges a

* *For a detailed article on this topic, see page 70.*

security interest on the crops, or the proceeds thereof, to a bank. The farmer loses his lease or mortgage, and the landowner/mortgagee harvests the crops, deducting the mortgage/lease payment for the time the crops were being harvested and the costs of harvesting. Courts have equitably subordinated the lender to the lessor/mortgagee on the theory that the lease or mortgage payments assisted the secured lender by allowing the crops to be harvested.[13]

In addition to unjust enrichment, other equitable theories have been applied to overturn UCC priorities. These include equitable estoppel, promissory estoppel, good faith and fair dealing, subrogation, equitable liens, mistake, alter ego, successor liability, or constructive trust.



Recommendations

In order to maximize recovery and minimize exposure to super-priority liens, secured lenders should consider the following practices:

- Be familiar with your customer's specific industry and determine if there may be potential exposure to industry-specific, super-priority liens, such as PACA.
- If the borrower is in an industry which may be subject to PACA liens, many lenders consider past-due payables as a potential PACA lien, and for that reason, deduct the amount of the past-due payables over 90 days from the borrower's credit availability, reducing the lender's exposure.
- Strong documentation will allow the lender to identify potential problems more quickly and, if necessary, declare a default based on financial covenants. Strong documentation requiring representations of events which may cause a lien to arise under ERISA or the tax code, complete financial disclosure, reimbursement for audits, and compliance with financial covenants will also assist the secured lender in spotting potential problems.
- Strong monthly reporting requirements, such as reports of payables, receivables and payroll taxes will also assist the secured lender in evaluating its customer's business status. There is no substitute for in-depth knowledge of the borrower's business, so that the lender can discern between normal business cycles and a problem loan.
- Routine audits will verify the borrower's reports, and assist the secured lender in spotting potential problems with super-priority lien claimants. The cost of an audit is usually less than $1,000 and is generally paid for by the borrower. Most lenders conduct them at least annually, and some quarterly.
- Routine lien searches through the office of the secretary of state of the borrower's state or the county recorder are an invaluable tool in determining if a super-priority lien has already attached to the secured lender's assets. One court has even made the impractical suggestion that secured lenders perform these searches every 45 days, or they may jeopardize their collateral position.[14] While damage may have already been done, the secured lender can avoid any further advances until the borrower solves the problem with the lienholder.
- Whenever possible, secured lenders should attempt to obtain fully perfected, choate liens on property of either the borrower or a guarantor. Borrowers may be motivated to divert receivables to pay super-priority lien claimants. If the lender holds choate liens on the principal's property, the principal may be less inclined to divert the receivables.

In conclusion, the secured lender financing receivables should be on constant guard for intervening super-priority liens. Ironclad documentation, a thorough knowledge of the borrower's industry, strong reporting requirements, and frequent audits and lien searches will assist the secured lender in avoiding, discovering and defeating these liens. ▲

Endnotes

1. *U.S. v. Pioneer American Insurance Co.,* 374 U.S. 84,88, 83 S.Ct. 1651, 1655 (1963).
2. *Shell Oil v. Capital Financial Services,* 170 B.R. 903, 907 (D.C. S.D. Tex. 1994) (account must be in existence prior to tax lien).
3. *First Interstate Bank v. Internal Revenue Service,* 930 F.2d 1521 (10th Cir. 1991).
4. *Trust Company of Columbus v. U.S.,* 735 F.2d 447, 449 (11th Cir. 1984) (bank had a prior security interest in deposit account to secure loan).
5. 31 USC §3713.
6. The bankruptcy code has its own order of distribution. *See e.g.,* 11 U.S.C. §507.
7. 29 USC §1368(a).
8. Perishable Agricultural and Commodity Act 7 U.S.C. §499e.
9. *In re Southland v. Keystone,* 132 B.R. 632, 637 (Bankr. BAP 9th Cir. 1991) (bank ordered to return collected receivables, but was allowed offset for costs of collection).
10. 7 USC §196.
11. 7 USC §197(b).
12. *In re Magic Restaurants,* 197 B.R. 455, 458 (Bankr. D. Del. 1996).
13. *In re Hoover,* 31 B.R. 432, 36 UCC Rep. Serv. 1348 (Bankr. S.D. Ohio 1983).
14. *Texas Oil & Gas Corp. v. U.S.,* 466 F.2d 1040, 1053 (5th Cir. 1972).

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