

Extra Precautions Help Lenders Weather a Volatile Economic Climate

By Gene Lasky

Thorough due diligence is more essential than ever.

Due diligence has always been a routine and essential part of the process of pursuing lending opportunities. In today's volatile economy, lenders should take extra measures to protect themselves from losses. To get a more accurate picture of the borrower's repayment potential and to ensure that any collateral related to the loan is secured, lenders can take a number of steps that go beyond routine due diligence. These additional steps help reveal hidden threats such as tax liens, judgments, pending litigation and improperly indexed Uniform Commercial Code (UCC) financing statements.

This article describes eight ways in which lenders can avoid costly surprises.

1. Double-Check the Accuracy of the Debtor's Name When Making UCC Filings

A UCC filing is only perfected if the filer gets the name right. The consequences of filing under the wrong name are illustrated in the case *In re: Tyingham Holdings, Inc.* (U.S. Bankruptcy Court for the Eastern District of Virginia, Richmond Division).

In this case, a secured party held a security interest in consigned inventory. The party attempted to perfect the interest by filing a financing statement with the Virginia State Corporation Commission. This financing statement listed the debtor's name as "Tyringham Holdings." The debtor was a Virginia corporation listed as "Tyringham Holdings, Inc." on the public records of the Virginia State Corporation Commission.

The standard search logic of the Corporation Commission was such that an official UCC search certified by the Virginia State Corporation Commission revealed a search conducted under the name

"Tyringham Holdings, Inc." but did not reveal the secured party's financing statement under the name "Tyringham Holdings."

Because the search using the correct name under the standard search logic did not disclose the financing statement, the court concluded that the financing statement was "seriously misleading." The court ruled that the secured party's security interest in the collateral was unperfected, and the collateral could be sold free and clear of any lien held by the secured party.

As this case shows, it is important to determine the debtor's correct name. One way to ensure that the correct name is being used is to conduct a corporate name verification search and to order copies of a company's articles of incorporation and any amendments thereto. (A similar step can be taken when the debtor is a limited liability company (LLC) or other registered business organization.) This additional due diligence will help eliminate the risk of any errors in accurately entering the debtor's name in the filing and help ensure the perfected status of a security interest.

2. Look for Tax Liens and Judgment Liens

Tax and judgment liens ordinarily apply to the same types of property covered by UCC liens. However, they are not consensual and they can be on file without the debtor having any knowledge of their existence. Thus, it is not enough to ask the debtor about tax and judgment liens. Creditors must be diligent in discovering their existence themselves.

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Although this may seem surprising, it is not uncommon for large corporations to not know about judgment liens. With the many corporate reorganizations, mergers, acquisitions, changes in outside counsel and the like, management of large corporations may indeed not know to whom it owes debts in cases related to judgments and litigation.

For example, executives for a large business entity were preparing the disclosure schedule for a large financing deal but had no idea about prior outstanding judgment liens. The judgment creditors had been able to secure the liens as a result of nonresponsiveness from the business. Apparently, these cases had gone unnoticed by management and counsel in the years prior. Because this judgment lien had priority, the prospective borrowers and lenders discovered that there was no property to offer to secure the loan.

The diligent lender will certainly want to know about tax and judgment liens before advancing any funds. Making tax lien searches and judgment lien searches a routine part of the diligence process will take care of this.

3. Be Sure to Include Common Name Variations When Searching for Tax Liens

When conducting searches, it is important to create an effective search strategy. The now infamous case of *In re: Spearing Tool and Manufacturing Co., Inc.* (U.S. Court of Appeals for the Sixth Circuit) shows why.

In this case, the lender and debtor entered into agreements that granted the lender a security interest in all of the debtor's assets. The lender perfected its security interest by filing financing statements, identifying the debtor as "Spearing Tool and Manufacturing Co.," its precise name as registered with the Michigan secretary of state's office. The debtor fell behind in its federal employment tax payments, and the Internal Revenue Service (IRS) filed two notices of federal tax lien against it with the Michigan secretary of state. Both of these tax liens identified the debtor as "SPEARING TOOL & MFG. COMPANY INC.," which varied from the precise Michigan-registered name by using an ampersand in place of "and," by abbreviating "Manufacturing" and by spelling out "Company." This was the name the debtor provided on some of its quarterly federal tax returns.

The lender periodically submitted lien search requests to the Michigan secretary of state, using the debtor's exact registered name. These searches never revealed the IRS liens, because the electronic search technology employed by Michigan disclosed only liens matching the precise name searched, not liens filed under slightly different or abbreviated names, as the IRS's was. Unaware of the tax liens, the lender advanced more funds to the debtor.

After the debtor filed a Chapter 11 bankruptcy petition, the lender finally discovered the tax lien notices. The lender then filed a complaint to determine lien priority. The court held that federal law governed the matter, noting that a reasonable, diligent search by the lender would have disclosed the IRS tax liens and that the IRS had priority.

Although the ruling is limited to the facts of this case and to the Sixth Circuit, this case reinforces the importance of including tax lien searches in a complete due-diligence plan. Future rulings may support the IRS's priority. In addition, the priority of federal tax liens over certain types of secured transactions is established in IRS Regulation 5.17.2.6.6.1 (Dec. 14, 2007).

4. Conduct Court Searches

Court searches are the best way to reveal the credit risk posed by civil suits and bankruptcy cases. These open court actions threaten to encumber property being pledged as collateral and can seriously affect a debtor's solvency.

In this example, lenders learned about a potentially large threat by accident. A large conglomerate was acquiring a privately owned business. During the due-diligence process, the business assured its legal counsel that it had disclosed everything pertinent for the litigation section of the disclosure schedule to the sale/merger agreement. During casual conversations that occurred as the deal was nearing its final stages, however, one of the executive officers told an anecdote about an employee who was injured while working on a piece of equipment. Upon further questioning, it was revealed that a suit was pending by the worker. Further, the worker was contemplating pursuing the case as a civil action outside of workman's compensation, which would increase the potential liability.

Rather than hope for casual conversation to reveal information on legal actions, a court search should be

conducted. Conducting a court search is reliable and inexpensive “insurance” to uncover the potentially significant risks of any legal actions your borrower may be involved in that could encumber assets. It can also shed light on the nature of the cases and the liability involved. Potential borrowers may indeed believe that they have disclosed everything they know regarding litigation. However, they may have overlooked a case or they simply may have thought that a matter was not important enough to mention.

When conducting court searches, it’s particularly important to include bankruptcy searches. Searches at the U.S. bankruptcy courts assist in the evaluation of a debtor’s credit risk. Like pending suits, bankruptcy cases cannot be revealed in the local filing office where liens reside. However, the inclusion of a borrower’s name as a petitioner in a bankruptcy proceeding is a clear red flag. If a company has filed for Chapter 11 bankruptcy, lenders will gain instructive insight into the borrower’s credit issues, whether they successfully executed their restructuring plan and how creditors were repaid.

Bankruptcy searches—along with litigation searches—are pertinent for many types of lending agreements, from credit agreements to large merger deals. In transactions that involve asset sales, these searches identify whether the assets are controlled by the borrower as they claim they are, that no other secured parties can lay claim to the assets and that there is no pending litigation that could encumber the particular assets.

5. Order a “Search-to-Reflect” After Making UCC Filings

Human error can occur even in the most highly automated environments. Errors occur in indexing the filing type and in listing the debtor and secured party names. Whether the error occurred in the original filing, or at the filing office, filers can uncover and correct such errors by ordering a search-to-reflect.

A secured party derives two key benefits from a search-to-reflect. The first is to confirm both the perfection and priority of the filing. A Revised Article 9-compliant search-to-reflect will disclose all legally effective UCC filings—that is, all filings that are not considered “seriously misleading” due to incorrect debtor names. And, once the search is conducted, a filer can be assured of its position relative to any other

UCC filings on the same collateral. The second benefit is to confirm that the jurisdiction has correctly indexed the debtor, filing type and secured party names.

For full peace of mind, a search-to-reflect should also include copies of the original filings. This full search gives the original filers and any subsequent searchers the opportunity to correct any errors found in the filings. Among the lenders who would most benefit from conducting a search-to-reflect are Small Business Administration (SBA) lenders—because of the SBA guidelines and guaranty—and creditors who are involved with high-dollar-value or high-risk deals.

6. Monitor Borrowers’ Business Entity Status

It is important for lenders to learn of changes to a borrower’s name and to learn if their business organization is no longer in good standing in its formation state. Not all borrowers notify their lender of these changes. This is true even though most security agreements include mandatory notification clauses and require debtors to respond to regular inquiries regarding their affairs. Article 9 of the UCC also has very specific, albeit complex, rules that require certain filings be made when a debtor changes its name, location or both. However, enforcing these requirements is a challenge.

The solution is for lenders to monitor borrowers themselves. Business entity monitoring provides notification to the lenders of name or status changes. In the case of a registered-entity debtor, the lender may also monitor new corporate, LLC, *etc.*, filings and amendments to existing filings. With defaults on the rise in the current economic environment, monitoring is an important best practice.

7. Monitor UCC Filing Activities

UCC filing monitoring notifies the lender if another secured party tries to amend, continue or terminate its UCC filing. It’s important to track any change to UCC filings that would undermine a lender’s position. Staying on top of this enables a quick response and protects the filer’s interest.

UCC filing monitoring is particularly important because when Revised Article 9 became effective,

signatures were no longer required for UCC filings. Many lenders became concerned about the possibility of a third party accidentally terminating its filing and of the increased possibility for fraud. Monitoring not only allows lenders to determine if other secured parties are adversely affecting their filings but allows them to ensure that they have not inadvertently terminated a filing from within their own operations.

UCC filing monitoring also notifies the lender of UCC filings made by another secured party. A brief example illustrates the importance of this type of monitoring. A bank had encountered a fraudulent debtor who had secured two loans simultaneously for the same collateral, one from the first bank and one from another bank. Unknowingly, the first bank continued to extend funds to the debtor until the debtor maxed out the credit line. The bank also found out that it was not in priority position for the secured assets. This could have been avoided with routine UCC monitoring. Incidentally, a search-to-reflect, as noted above, would also have caught the fraud.

There are other benefits to ongoing monitoring. For example, secured lenders who have particular restrictions in their security agreements—such as a clause that restricts a debtor's ability to secure alternative financing—can use this as a vehicle to monitor compliance. Another benefit to monitoring UCC filings would be to receive notice of correction statements (from the filing office or a private party). In addition, regular monitoring can help reveal when IRS liens have priority, so that lenders will be well aware of assets that are not available to secure a loan.

8. Don't Forget Patriot Act and U.S. Economic Sanctions Program Searches

Patriot Act searches are now a vital part of due-diligence searching with any financial transaction.

Section 326 of the Patriot Act requires banks to have a written Customer Identification Program (CIP). The CIP must be incorporated into the bank's Bank Secrecy Act/Anti-Money-Laundering compliance program, which is subject to approval by the bank's board of directors. The CIP must include procedures for determining whether a potential or current customer appears on any federal government list of known or suspected terrorists, terrorist organizations or is otherwise subject to a U.S. economic sanctions program. The federal government's list of people and companies subject to a sanctions program is called the Specially Designated Nationals and Blocked Person List (SDN). The U.S. Treasury's Office of Foreign Asset Control (OFAC) maintains the SDN List.

While Patriot Act and economic sanctions program searches have only an indirect bearing on determining a debtor's creditworthiness or securing collateral for financing, failure to include them in a solid due-diligence plan can result in onerous penalties. The fines imposed by OFAC in 2008 on financial institutions are often the result of a failure to identify the customer and to check the customer against the SDN list. Although OFAC has yet to impose a fine upon a lender for extending credit to a person on the SDN list, the statute underlying the SDN list provides specific authority to impose just such a fine.

Due Diligence: More Important Than Ever

Thorough due diligence is more essential than ever and is not an area to scale back or cut corners on. By taking a few additional measures, financial institutions, leasing companies and commercial finance organizations can better protect themselves against foreclosures and large write-downs.

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