June 23, 2005

TO ALL MEMBERS OF THE UNIFORM
COMMERCIAL CODE COMMITTEE:

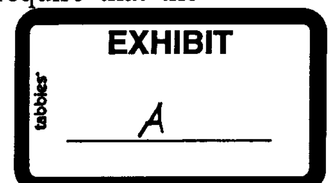
Re: New Sixth Circuit Decision on Priority of Federal Tax Liens

On June 21, 2005, the Sixth Circuit Court of Appeals issued its opinion in United States of America v. Crestmark Bank (In re: Spearing Tool and Manufacturing Co., Inc.), which bears case number 04-1053. This decision involved a lien priority fight between Crestmark Bank, a holder of a first-to-be filed security interest in the personal property of a Michigan corporation named "Spearing Tool and Manufacturing Co., Inc.," and the Internal Revenue Service, asserting a federal tax lien in all personal property of the debtor. Crestmark Bank filed its UCC financing statement under the correct corporate name of the debtor in 1998. The IRS filed two notices of tax liens under an incorrect name, "Spearing Tool *& Mfg.* Company Inc."

Crestmark periodically requested lien searches from the Michigan Secretary of State using the exact name of the debtor. The State's search logic disclosed only liens matching the precise name used, so the IRS liens did not show up on these searches. However, search results returned to Crestmark by the State in February 2002, after the IRS filings, contained a handwritten note stating, "You may wish to search using Spearing Tool & Mfg. Company Inc.", which was the name used by the IRS in its tax lien filings. Crestmark, however, did not search under this name variation.

On April 16, 2002, Spearing commenced a Chapter 11 case in the United States Bankruptcy Court for the Eastern District of Michigan and, shortly thereafter, Crestmark discovered the existence of the IRS liens. Crestmark then commenced an adversary proceeding in the bankruptcy court seeking a determination of lien priorities. The bankruptcy court ruled that the IRS lien had priority over Crestmark's, refusing to apply the rules of Article 9 of the UCC that depend upon the search logic used by the proper filing office. The federal district court reversed the bankruptcy court, finding that those rules applied and, because Michigan's search logic did not result in the disclosure of the IRS lien, Crestmark's security interest was entitled to priority. On further appeal, the Sixth Circuit agreed with Bankruptcy Judge Steven Rhodes below, reversing the district court and affirming the bankruptcy court's grant of summary judgment in favor of the IRS.

In its opinion, the Sixth Circuit first held that federal law, not state law, determines the priority of federal tax liens and cited provisions of the Internal Revenue Code and Treasury Regulations. Case law decided under these statutes and regulations did not require that the



precise name of the corporate debtor be inscribed on the notice of tax lien. According to the Court, the "critical issue in determining whether an abbreviated or erroneous name sufficiently identifies a taxpayer is whether a 'reasonable and diligent search would have revealed the existence of the notices under these names.'" The Sixth Circuit, in reviewing the facts, held that Crestmark did not conduct such a reasonable and diligent search because Crestmark failed to search under abbreviations, especially when the Michigan Secretary of State's office specifically recommended that such a search be done. However, the Court emphasized that it was expressing no opinion about "whether creditors have a general obligation to search name variations. Our holding is limited to these facts."

The Sixth Circuit next stated that federal public policy considerations supported a ruling in favor of the IRS and against Crestmark--a requirement that "tax liens identify a taxpayer with absolute precision would be unduly burdensome to the government's tax-collection efforts." Furthermore, to require the federal government to comply with each state's electronic-search technology conflicted with the overriding "principle of uniformity which has been the accepted practice in the field of federal taxation."

Finally, the Court rejected Crestmark's argument that IRS liens must satisfy the same "precise identification requirement" under revised Article 9 of the UCC. The Court first observed that section 9-109(a)(1) of the UCC applies only to consensual security interests in personal property and not involuntary liens like the IRS'. Second, citing prior United States Supreme Court precedent, the Sixth Circuit announced that the United States, "as an involuntary creditor of delinquent taxpayers, is entitled to special priority over voluntary creditors" such as Crestmark.

For bank counsel, the obvious lesson to be learned from this decision is that if your client becomes aware that its borrower sometimes uses a variant of its correct corporate name in its business, the bank should conduct periodic lien searches in the proper state under those variants in addition to the borrower's correct legal name. This action should mitigate the risk of having the bank's security interest in after-acquired personal property collateral (e.g., inventory and accounts) being primed by an IRS lien through the application of the 45-day rule. The more interesting issue is the one specifically not addressed by the Sixth Circuit: does a secured creditor have a "general obligation to search name variations." This issue is now probably ripe for decision in priority disputes between tax liens and consensual security interests.

Very truly yours,

Patrick E. Mears

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