

DEVELOPING A LIEN SEARCH STRATEGY FOR LEGAL DUE DILIGENCE

Author Elina Balagula



“When performing legal due diligence, one of your primary goals is to uncover hidden legal liabilities, historical and pending, that come with the deal.”

When performing legal due diligence, one of your primary goals is to uncover hidden legal liabilities, historical and pending, that come with the deal.

However, your plan of attack can be dramatically influenced by several factors, including the type and size of the deal, the industry, time constraints, and more.

Knowing what to look for can be challenging. Are you covering the right items? Could you be wasting time on non-relevant, low-priority areas? Or are you overlooking something important?

Balancing the amount of time and money spent on a transaction, while minimizing risks, can be a juggling act.

Here are some tips for optimizing your search strategy.

ESTABLISH THE PARAMETERS

When determining what to search for, it's important to first answer these four questions:

1. Who are the parties?

Consider who your client is and how well you know the parties.

Are you dealing with a long-standing client of the firm? If so, you may already have significant information on them internally. If the client is new, then you may need to answer more questions. If the debtor is a partnership, you may also want to know who the partners are. If your debtor is an LLC, you may want to know who the members are and be prepared to perform due diligence on these parties.

Knowing what to look for can be tricky. A lender will want to know about liens and assets, but not all of them may be relevant. For example, a purchase money security interest (PMSI) may not have a bearing on the deal because this special type of lien only extends to purchase-money collateral. On the other hand, a bankruptcy trustee will be interested in all liens and assets to properly administer the bankruptcy estate.

Be sure to go beyond the parties' representations as they may be incomplete. For instance, if you come across a lien that has not been terminated, it is best practice to confirm with the secured party directly that the underlying obligation has been satisfied and request that a UCC-3 termination statement be filed.

continued on page 2

This information is not intended to provide legal advice or serve as a substitute for legal research to address specific situations.

2. What is the transaction type?

The type of transaction will dictate your due diligence and lien search checklists. A cross-border deal, for example, may involve cross-border lien searches.

Certain industries will also determine due diligence best practices and the types of searches that need to be performed. An automotive deal will require DMV searches, while a technology deal may involve IP searches and filings. If the debtor was involved in environmental clean-up, EPA lien searches should be included. It is a good idea to consider a universe of different lien types and compare it against the factual background of your deal.

Depending on the type of deal, representations and warranties will also change. Secured loan transactions typically require a borrower to represent that assets have not been pledged to anyone else, that the borrower will not change its name, move to another jurisdiction, or perform other actions that would impact the lender's status and the lender's prior written consent. In these cases, your due diligence will involve confirming that such representations are accurate, which may include continued post-closing monitoring to ensure that the borrower follows the terms of the agreement. This may involve periodic lien searches and/or confirming that the entity has not changed their name, relocated to another jurisdiction, or transferred your client's collateral.

Finally, if obtaining personal guarantees, you may want to run individual lien searches and litigation searches on the guarantors.

3. How large is the transaction?

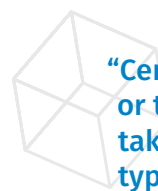
The size of the transaction will determine the budget and amount of time spent on due diligence, with larger businesses and transactions typically requiring more investment.

As you establish the parameters of due diligence, consider budget constraints. Even large deals may have budget caps, and it is often up to the professionals and their clients to determine how much they are willing to spend on due diligence versus how much risk they are willing to tolerate.

4. What is the timeline?

Managing expectations is one of the most important due diligence considerations. Adequately managing costs and timing can help ensure that a closing goes smoothly.

Timelines are often dictated by business needs, tax implications, and availability of information, among other things. There are several factors that can impact closing dates. Legislative changes, for example, can add more steps or requirements that may delay your ability to deliver. If a transaction implicates cross-border searches, you need to factor in turnaround times in foreign jurisdictions. Sometimes even domestic turnaround times can be unpredictable, particularly if they are impacted by unforeseen events or disasters, as we've seen with the COVID-19 pandemic. These can mean government office closures and operational delays. Even expedited services may take days instead of hours.



“Certain aspects of the deal — such as its size or the related industry — could lead you to take a deeper dive into less common lien types or hidden liens.”

It is paramount to work with a provider who can adequately provide time estimates, both domestically and abroad. Look for one who maintains constant communication with filing offices, so that you can best manage the timing of your client's deal.

Ultimately, the scope of due diligence is a business decision that must be made by the clients you represent. The more open you are about the scope, timing, and cost, the less chance there is for a client to allege negligence for failure to uncover a lien.

COMMON LIENS AND SEARCHES

The five-part due diligence search

While firms and service providers across the country may group common searches differently, a deal typically includes the following standard due diligence searches:

1. Uniform Commercial Code (UCC) liens
2. Fixture filings (found in the property records at the county level)
3. Tax liens (federal and state) and judgment liens
4. Bankruptcy (federal courts)
5. Pending litigation (federal and state courts)

continued on page 3

This information is not intended to provide legal advice or serve as a substitute for legal research to address specific situations.

UCC liens

UCC liens are governed by UCC Article 9, which applies to secured transactions. More specifically, UCC liens apply to consensual security interests, such as when a company takes out a loan and grants a lender a lien on all or some of its assets. Non-consensual liens, such as tax liens and judgments liens — where the debtor did not consent to the lien — are not covered by the UCC. The reason this is significant is because the UCC has specific rules concerning the debtor's name and filing location, while non-consensual liens do not have to follow the same rules. As a result, the debtor name under which you search UCC liens and non-consensual liens and the location where you search for them may be different.

For example, when searching for UCC liens you should search using the debtor's name listed on the "public organic record". For registered entities that means the name listed on the entity's formation documents and any amendments thereto. The searches should be performed at the state's central filing office (the Secretary of State's office in most states) where the debtor is located. For non-registered entities, the searches should be performed at the location of the entity's chief executive office. For individuals, the search should be done where the individual is domiciled. And let's say, if the individual lives in New York and spends three to five months in Florida, it is best practice to search in both states.

Fixture filings

Fixture filings fall under the UCC and thus largely follow UCC rules, but a few items are worth pointing out. A "filing on fixtures" involves filing a UCC-1 describing the fixture in the collateral description. These are filed at the state level following standard UCC rules described above. "Fixture filings" should be searched for in the county filing office where the real property is located and may come in the form of a UCC-1 and the UCC-1 Addendum, or as a mortgage.

Federal tax liens, state tax liens, and judgment liens

These non-consensual liens may have different naming protocols. The government may file a lien under a different name than what is required under the UCC and have superior rights.

Keep in mind that the IRS can file under a DBA or a name on the debtor's tax return, and this name may not be revealed under a regular UCC search — although the IRS would still have priority. There are a number of cases that illustrate

how courts side with the government in these situations. For example, In *re Spearing Tool and Manufacturing Co., Inc.* (412 F.3d 653 (6th Cir. 2005)), the IRS filed a federal tax lien against "Spearing Tool & Mfg. Company, Inc.", which was not reflective of the debtor's name on the "public organic record." Yet the court found that the IRS still had priority over another secured party who did file against the true legal name of the debtor, reasoning that "[a] requirement that the tax liens identify a taxpayer with absolute precision would be unduly burdensome to the government's tax-collection efforts" and that burden is on the other creditors to perform "reasonable and diligent" searches.

Federal and state tax liens, and judgment liens can be found at the county or state level, or both, depending on the jurisdiction. It's important to keep in mind that these liens do have expiration dates, which vary by lien type and jurisdiction. So when reviewing lien search results, it's a good idea to check whether a lien is still valid.

Bankruptcy searches

A bankruptcy case for business entities can be commenced in any federal district court in the debtor's state of domicile (i.e. state of formation), where the debtor maintains its principal place of business, or where the debtor has its principal assets. For individuals, a case would typically be commenced in the debtor's state of residence or where the debtor's assets are located. So it would be prudent to search in federal courts that are located in any of the aforementioned jurisdictions. Note that bankruptcy courts are functions of the district courts, and thus bankruptcy cases as a matter of practice are commenced at the bankruptcy courts but may be appealed to the district courts.

Pending litigation

When formulating your due diligence strategy you may want to consider searching for pending litigation against the debtor and the guarantor(s), and potentially any other parties significant to the transaction, such as officers or members. It may be difficult to uncover every possible litigation, but typically searches are done in the superior courts (or jurisdictional equivalent) where the entity has its principal place of business or chief executive office, as well as state and federal courts. If real estate is involved, it is good to also search in the county where the real estate is located. In addition, you may want to consider running searches in criminal courts if individuals are involved.

continued on page 4

LESS COMMON LIEN TYPES AND SEARCHES

Certain aspects of the deal — such as its size or the related industry — could lead you to take a deeper dive into less common lien types or hidden liens. These can include the following:

- › Real property records (owner and encumbrance)
- › Department of Motor Vehicles (DMV)
- › Boats and aircraft
- › Business licensing records
- › Mobile home records
- › International liens
- › Mechanics liens, ERISA liens, EPA liens, hospital liens
- › Tribal searches
- › Intellectual property (patent and trademark)
- › Global, non-U.S. searches (see [Performing Lien and Court Searches Outside the U.S.](#))
- › Know your customer (KYC) – Patriot Act/OFAC (doing a deal with a person on the OFAC list could lead to financial penalties), anti-money laundering, negative news, and media searches

Considering other lien types allows you to expand the scope of the project from the beginning and prevents surprises down the road. You may discover an issue that your client hadn't thought of that could affect the price of the company or cause post-closing problems. The more you can be aware of at the onset, the fewer problems you and your clients will encounter later.

These less common lien types and searches will not be part of every transaction. But it's a useful checklist to have on hand when reviewing a deal to see if these types of searches could apply.

Tip: Many of these lien searches can be outsourced to vendors. For more information read [Uncovering the Hidden Liens That Can Affect Your Deal](#).

ADDITIONAL TIPS

Here are a couple of other factors that could influence your searches.

Historical and pending litigation

Active cases, open court actions, and pending lawsuits can all threaten to encumber property that is pledged as collateral or can seriously impact a debtor's solvency. Closed cases may reveal concerning information related to your debtor and/or guarantor(s), such as allegations of fraud. In addition, in some jurisdictions, such as New York, judgment liens attach automatically to the debtor's real property located in that jurisdiction. Your due diligence should, therefore, include a review of the litigation history of the company and any open or closed cases. Consider running litigation searches on the guarantors as well.

Debtor name accuracy

Listing the correct debtor name on a UCC search is critical. But for search purposes, it is advisable to run broad-based searches. As the party doing search due diligence, you want to uncover as many liens as possible — even against former names. Filing requirements are different; these must be made against the exact legal name of the debtor or the name of the “public organic record.”