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So You Thought You Had a Senior Lien? Losing Priority under Wisconsin and Federal Law (and Other Lender Nightmares)

By Peter C. Blain*

This article addresses the dangers of subsequently arising and sometimes hidden liens and claims which can prime a secured lender's priority position.

Lenders base their credit decisions on their assessment of the likelihood that the loans advanced will be repaid. To the extent possible, prudent lenders ensure that their loans are properly secured by collateral, and that their liens are senior in priority to all other existing liens or claims. However, even if a lender does everything correctly when closing the loan, subsequent events in the life cycle of a borrower can affect existing liens or create competing liens threatening the priority of a lender's position and diminishing the prospects of repayment in full.[1] These events and their consequences keep lenders up at night.

Some subsequent events can be anticipated and up-front steps, such as the establishment of appropriate reserves, can be taken to protect the lender in the loan documentation process. Other events are on the horizon, but difficult to predict with certainty. Here, it is imperative that a lender diligently monitor its borrower and react swiftly to protect its lien priority position. Still other events, especially events arising in bankruptcy proceedings, are very difficult to anticipate and the lender's recourse is to weigh the possibility of its liens being adversely affected in the future when making the initial credit decision. While no one plans for a bankruptcy at a loan closing, a prudent lender will sleep more soundly if thought is given to the terrible "what if" in advance of disaster striking.

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[1] This article addresses the dangers of subsequently arising and sometimes hidden liens and claims which can prime a secured lender's priority position. It does not address other subsequent circumstances which may cause a lender to lose its priority position, such as the lapse of a financing statement (*see* Wis. Stat. § 409.515), a financing statement becoming seriously misleading because of a debtor's name change or merger (*see* Wis. Stat. § 409.507) or the lender failing to properly perfect liens in property not covered by the Uniform Commercial Code ("UCC") (*see* Wis. Stat. § 409.109), events which are also worrisome for lenders.

State and federal statutes, including the U.S. Bankruptcy Code,[2] are the genesis of most of these competing, and sometimes "hidden," liens or other priority disruptions. It is useful to focus on some of these competing statutes and circumstances, and discuss how they undercut a lender's priority position, jeopardizing the protection the lender bargained for. Some of the priming scenarios are fairly common; others less so. However, all can potentially significantly and negatively impact a secured lender's position.

LIEN DISRUPTIONS OUTSIDE OF A BANKRUPTCY PROCEEDING

This first part of the article explores the various priority challenges facing a lender that may assume (perhaps incorrectly as we will see) that its first-in-time lien perfection will permanently ensure its senior positon. Here, the focus is on statutes other than the Code. The second part focuses on various provisions of the Code that limit or otherwise adversely affect a lender's secured position. Finally, the third part concludes with a brief look at statutes or circumstances that do not create senior liens, but that otherwise negatively impact a lender's ability to realize upon its collateral. As Bette Davis said: "Fasten your seat belts, it's going to be a bumpy [ride]."[3]

Purchase Money Security Interests

Let's start with an easy one. Purchase money security interests ("PMSI") allow a subsequent creditor to have priority over an existing lienor. A purchase money obligation is one in which the lender extends credit to the debtor to allow the debtor to acquire rights in the collateral.[4] So long as the PMSI is in goods other than inventory and is perfected within 20 days of the date the debtor receives possession of the goods, the PMSI lienor has priority over the liens of a preexisting lender.[5] With respect to PMSIs in inventory, the PMSI lender has senior priority so long as:

1) the PMSI is perfected when the debtor receives possession of the inventory;
2) the PMSI lender sends an authenticated notice to the holder of the conflicting security interest;
3) the holder of the conflicting security interest receives the notice within five years of the date the debtor takes possession of the inventory; and

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[2] *See* 11 U.S.C. § 101-1532, hereinafter sometimes referred to as the "Code."

[3] All About Eve, Twentieth Century Fox Film Corp. (1950).

[4] *See* Wis. Stat. § 409.103(1)(b).

[5] *See* Wis. Stat. § 409.324(1).

4) the notice says the PMSI lender intends to take a PMSI and describes the inventory.[6]

Although bank lenders routinely protect themselves from PMSIs by including covenants in their loan documents limiting the amount of permissible PMSI loans, nonbank lenders not familiar with PMSIs can find their lien protections eroded by these liens.

Liens for Real and Personal Property Taxes

Real and personal property taxes are deemed levied when the tax roll is delivered to the local treasurer.[7] They become a lien on the property effective January 1 of the year in which they are levied, and are superior to all other liens.[8] While local taxing authorities are generally uniform in enforcing their rights with respect to real property tax liens, municipalities are distinctly non-uniform with respect to liens for personal property taxes, even though the statute clearly gives personal property taxes senior priority. Milwaukee County, for example, historically has not enforced its rights to assert a senior lien for personal property taxes in Wisconsin bankruptcy or receivership proceedings. Prudent lenders will periodically check to make sure property taxes are paid when due to avoid an unwelcome surprise.

Federal and State Income Tax Liens

Federal income tax liens on personal property are filed with the Wisconsin Department of Financial Institutions.[9] Federal income tax liens on real property are filed with the county register of deeds.[10] Wisconsin Department of Revenue Tax Warrants for state income taxes are filed with the clerk of courts of the county in which the property subject to the lien is located.[11] Liens for federal and state income taxes are subordinate to liens of record perfected prior to the filing of federal or state tax lien for income taxes.[12] However, under both the Internal Revenue Code and the Uniform Commercial Code ("UCC"), upon filing of the tax lien, the secured lender retains its priority only for advances made without knowledge of the tax lien within 45 days after its filing. Advances made more than 45 days after the filing of the tax lien retain their priority only

[6] *See* Wis. Stat. § 409.324(2).

[7] *See* Wis. Stat. § 70.01.

[8] *Id.*

[9] *See* Wis. Stat. § 779.97.

[10] *Id.*

[11] *See* Wis. Stat. § 71.91(5)(ar).

[12] *See* Wis. Stat. § 71.91(4); 26 U.S.C. § 6323.

if they are made without knowledge of the tax lien, or pursuant to a commitment to lend entered into without knowledge of the lien.[13] A lender that does not regularly check the status of tax liens filed against its debtor may be surprised to find that its senior lien position has been substantially eroded.

Wage Liens

In Wisconsin, Chapter 109 of the Wisconsin Statutes gives employees a lien for unpaid wages and benefits that can be enforced either by the employee or by the Wisconsin Department of Workforce Development ("DWD"). In addition, employers with 50 or more full time employees (excluding new or low hour employees, and also excluding officers, directors and commission sales people, among others) are obligated to give a 60 day plant closing notice if a business closes or a mass layoff occurs.[14] The DWD will assert a lien on behalf of employees for the number of days less than 60 a required plant closing notice is not given. The wage lien, which takes effect when it is filed with the clerk of the circuit court in the county in which services were performed,[15] is senior to all other liens up to $3,000 per employee with respect to the preexisting liens of commercial lending institutions.[16] However, the wage lien is senior and unlimited with respect to the prior liens of noncommercial lending institution lenders.[17] Owners of closely held businesses, or other lenders that are not commercial lending institutions (such as venture capital funds not in the business of making loans to businesses in the state) that extend secured loans, could find their liens completely swamped by a significant wage lien.

Construction Liens

Construction liens protect those that furnish goods or services in connection with the improvement of real estate, and arise from the first visible commencement of work by the lien claimant.[18] Construction liens must be filed with the clerk of the circuit court (rather than the county register of deeds where mortgages are recorded) within six months of the date services or goods were provided,[19] and are senior to any subsequently recorded mortgage, provided the

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[13] *See* 26 U.S.C. § 6323; Wis. Stat. § 409.323 (2).

[14] *See* Wis. Stat. § 109.07.

[15] *See* Wis. Stat. § 109.09.

[16] Defined in Wisconsin Statutes Section 234.01(5k) as including certain institutions that provide commercial loans in Wisconsin.

[17] *See* Wis. Stat. § 109.09.

[18] *See* Wis. Stat. § 779.01(4).

[19] *See* Wis. Stat. § 779.06.

lien claimant did not have actual notice of the mortgage.[20] An important exception to the priority rule involves construction mortgages subsequently recorded by state and national banks, state and federally chartered credit unions, savings banks, savings and loan associations, and most governmental agencies.[21] Lenders omitted from the preferred status conferred on the foregoing parties, such as private equity funds, venture capital funds, finance companies, nonbank asset based lenders and insiders of the borrower may find their lien position eroded by a construction lien filed long after the mortgage is recorded.

Theft by Contractor

Wisconsin Statutes Section 779.02(5) provides that funds paid to a prime contractor or subcontractor by the owner of real property becomes a trust fund in the hands of the prime contractor or subcontractor, but not in the hands of any other person, for the benefit of suppliers, materialmen or labors who provide goods or services related to the improvement of real property. The Wisconsin Supreme Court has made clear that a lender who receives and applies payments from a prime contractor or subcontractor to a loan secured by accounts receivable will not have to return the money pursuant to this section.[22] However, the court has also ruled that a lender with a lien on accounts receivable that has not applied to funds to the loan,[23] or that has rights of setoff against its borrower/depositor,[24] will be subject to trust fund rights of construction materialmen or suppliers, even if the construction lienholders fail to perfect their respective lien rights.[25]

Wisconsin Statutory Liens

Wisconsin has a variety of liens that arise by statute. Some of them are possessory, and Wisconsin's UCC accords them priority over prior filed security interests in goods unless the statute that created them provides otherwise.[26] For example, mechanics have a senior lien for work done on various items of personal property in their possession, including motor vehicles, of between $1,500 and $9,000, depending upon the type of good or the weight of the

[20] *See* Wis. Stat. § 779.01(4).

[21] *See* Wis. Stat. § 706.11.

[22] *See Schneider Fuel & Supply Co. v. W. Allis State Bank,* 70 Wis. 2d 1041, 236 N.W.2d 266 (1975).

[23] *See Wis. Dairies Coop. v. Citizens Bank & Tr.,* 160 Wis. 2d 758, 467 N.W.2d 124 (1991).

[24] *See Kraemer Bros., Inc. v. Pulaski State Bank,* 138 Wis.2d 395, 406 N.W.2d 379 (1987).

[25] *See Wis. Dairies Coop.,* 160 Wis. 2d at 770.

[26] *See* Wis. Stat. § 409.333(2).

vehicle, and a senior lien for work performed on boats up to $1,200.[27] Similarly, motor carriers have senior liens between $100 and $1,500 for towing and storing motor vehicles, depending upon the weight of the vehicle,[28] and hotels, livery stables, garages, marinas and pastures have a senior possessory lien up to $1,200. Liens on plastic fabricating tooling and products in the fabricator's possession are accorded no priority over existing security interests,[29] while loggers, lumber mills,[30] and miners[31] have a nonpossessory lien on goods for services provided, which is senior to all other liens and encumbrances and is not limited in amount. Other statutory liens include those arising in favor of cooks,[32] jewelers,[33] animal breeders,[34] brokers,[35] and hospitals,[36] among others, reflecting the legislature's reaction to the importunes of various special interests.

Common Law Bailee's Lien

Even broader than statutory mechanics' liens are common law bailee's liens, which may be claimed by parties who are in possession of another's products that they have processed or enhanced in some way. The lien is broader in scope than statutory liens because the entire money value of work done on a lot of goods can be assessed against that portion of the lot remaining in the bailee's possession.[37] The bailee's lien has its origins in the 19th century,[38] but the doctrine was reaffirmed in 2000.[39] Courts have held that although various mechanics' liens have been codified in Chapter 779 of the Wisconsin Statutes, codification has not abrogated common law bailee's liens.[40] However, courts have also held that where the common law bailee's lien also constitutes a

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[27] *See* Wis. Stat. § 779.41.

[28] *See* Wis. Stat. § 779.415.

[29] *See* Wis. Stat. § 779.47.

[30] *See* Wis. Stat. § 779.18.

[31] *See* Wis. Stat. § 779.35.

[32] *See* Wis. Stat. § 779.31.

[33] *See* Wis. Stat. § 779.46.

[34] *See* Wis. Stat. § 779.49.

[35] *See* Wis. Stat. § 779.45.

[36] *See* Wis. Stat. § 779.80.

[37] *See Moynihan & Assocs., Inc. v. Hanisch,* 56 Wis. 2d 185, 201 N.W.2d 534 (1972).

[38] *See Aviaus v. Brickley,* 65 Wis. 26, 26 N.W. 188 (1885).

[39] *See Cummins Great Lakes, Inc. v. Cam Constr. Co. (In re Cam Constr. Co.),* 248 B.R. 134 (Bankr. W.D. Wis. 2000).

[40] *See Moynihan*, 56 Wis. 2d at 536.

statutory lien, the statutory dollar limitations on senior lien priority described above should apply.[41] Where there is no applicable statute, an argument can be made that the priority of common law bailee's liens is not limited because Wisconsin Statutes Section 409.333(1)(b) recognizes liens arising by rule of law and gives such liens priority over other liens unless a statute provides otherwise.

Landlords' Liens

Section 407.209 of Wisconsin's UCC provides that warehousemen have a lien on the bailor's goods for storage, transport, labor and related charges. However, the lien of a warehouseman arising under the statute is normally not senior in priority to a prior perfected security interest. An exception arises if a hypothetical bona fide pledgee would take precedence over the rights of the security interest holder. While, in most cases, a secured lender would not have entrusted its debtor's goods to the warehouseman such that the warehouseman would enjoy bona fide pledgee status, where storage of the goods in a warehouse is done with the acquiescence of the secured lender, and where warehouse liens are enumerated as permitted liens under a credit agreement, courts will find the warehouse lien to prime the lien of the secured party.[42] Lenders should take note of this when drafting loan documents to avoid inadvertently losing their senior priority.

ERISA Liens

Two types of liens arise in favor of the Pension Benefit Guaranty Corporation ("PBGC") under the Internal Revenue Code and the Employee Retirement Income Security Act of 1974 ("ERISA"). The first arises when a company fails to make required plan contributions in excess of $1 million.[43] The second arises upon the termination of underfunded plans and has no minimum threshold.[44] Both liens are perfected in the same manner as federal tax liens.[45] Like federal tax liens, the prior perfected secured lender retains its priority only for advances made within 45 days after the filing of the PBGC's lien, provided the lender did not have actual knowledge of the lien. Importantly, both types of lien encumber not only the assets of the debtor, but also the assets of any member of a controlled group of which the debtor is a member. This means that where a

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[41] *See W. Allis Indus. Loan Co. v. Stark,* 197 Wis. 363, 222 N.W. 310 (1928).

[42] *See In re Sharon Steel Corp.,* 176 B.R. 384 (Bankr. W.D. Pa. 1995).

[43] *See* 26 U.S.C. § 430(k).

[44] *See* 29 U.S.C. § 1368. The amount of the lien is limited to the lesser of (1) the liability owed or (2) 30 percent of the collective net worth of the plan sponsor and the members of the controlled group as determined by the PBGC.

[45] *See* 26 U.S.C. § 6633.

controlled group exists, not only the property of the debtor but the property of its affiliates and owners that are members of the controlled group may become subject to the lien. Unsuspecting lenders to the debtor's affiliates (rather than to the debtor/plan sponsor) may find their liens against their affiliate/borrower's assets securing new advances junior in priority on and after the 46th day after the filing of the PBGC's lien against the plan sponsor and the members of the controlled group.

PSA and PACA Trusts

The Packers and Stockyards Act[46] ("PSA") protects the unpaid qualified sellers of livestock and live poultry by the creation of a statutory trust. Similarly, the Perishable Agricultural Commodities Act[47] ("PACA") creates a trust in favor of the qualifying unpaid sellers of fresh produce. These trusts, once arising, reflect Congress's intention to create rights superior to the liens of lenders who have taken security interests in the accounts receivable of meat and poultry packers, and processors of fresh produce.[48] (A different result may be obtained if the interest in the accounts results from a true sale of the accounts rather than the creation of a security interest.)[49] While a lender that receives payment from the proceeds of a debtor's accounts receivable may have the status of a bona fide purchaser and be able to retain the payments made,[50] if the seller has knowledge of the PSA or PACA trust's violation upon receipt, it will be forced to disgorge the payments received.[51] A conservative working capital lender to meat and poultry packers or fresh produce processors could attempt to protect itself by reserving the amount of trade payables owed to qualifying sellers against the debtor's borrowing base (delineating the amount that can be borrowed). However, risk is on the lender, and borrowing base reserves will not protect the lender's lien from being trumped by these statutory trusts.

THE EFFECT OF BANKRUPTCY PROCEEDINGS ON EXISTING LIENS

The filing of a bankruptcy petition may have an immediate and profound

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[46] *See* 7 U.S.C. § 181-229(c).

[47] *See* 7 U.S.C. § 499a-b.

[48] *See* S. Rep. No. 94-932 at 5 (1976), *as reprinted in* 1976 U.S.C.C.A.N. 2267, 2271; Jason Binford and John Kane, *Farmer Favoritism: Statutory Protections for Creditors in Agricultural Bankruptcy Cases,* 46 Tex. Tech. L. Rev. 377 (2014).

[49] *See Endico Potatoes v. CIT Group/Factoring,* 67 F.3d. 1063 (2d Cir. 1995).

[50] *See C.H. Robinson Co. v. Tr. Co. Bank, N.A.,* 952 F.2d 1311 (11th Cir. 1992).

[51] *See Nickey Gregory Co. v. AgriCap, LLC,* 597 F.3d 591 (4th Cir. 2010).

effect upon the extent and priority of a secured party's liens. Various sections of the Code permit a debtor and other parties in interest to adversely impact a secured party's position. Lenders should take note of these potential impacts and the likelihood of a bankruptcy filing when engaging in workout negotiations with distressed borrowers.

Limitations on the Extent of the Liens—Code Section 552

Code Section 552 limits liens on property acquired after the filing of the bankruptcy petition to the proceeds, products, offspring or rents of prepetition collateral. Property of the debtor that is newly created or acquired after the bankruptcy filing is not subject to the prepetition lender's lien, notwithstanding the grant of liens in after-acquired property by the debtor to the lender in the loan and security documents.

Debtors often offer to continue the lender's lien post-petition in property of the same type as was encumbered prepetition as adequate protection for the use of prepetition cash and other collateral under Code Sections 363 and 361, or to collateralize post-petition financing under Code Section 364. However, if debtor in possession financing is provided by a third-party lender, or if there is a sufficient equity cushion of aggregate collateral value as compared to the indebtedness allowing a court to find that the lender is adequately protected, the lender's lien in post-petition collateral will be cutoff. This may result in a lender having to rely upon machinery, equipment or real estate to repay its loan instead of accounts receivable and inventory, which in many cases are much easier to liquidate.

Limitations on Liens—Code Section 506

Code Section 506 provides that a claim secured by a lien on the debtor's property is limited to the value of such property. That is, if the indebtedness is greater than the aggregate value of the collateral securing it, the lender has a secured claim in the bankruptcy case for the value of the collateral, and an unsecured claim for the amount of the indebtedness over the collateral value. The debtor may request that the collateral value be determined by the bankruptcy court at various times during the bankruptcy case. For example, valuation of the lender's interest in collateral will become important in determining whether and to what extent the lender is entitled to adequate protection, or in determining how a lender may be treated in a plan of reorganization. In addition, if a lender is found to be under-secured, its rights to post-petition interest, and reasonable fees and expenses incurred in protecting its interests, are cut off despite these expenses being agreed to by the debtor in the loan documents. In a protracted case, this could accumulate to a substantial sum.

Changes in Lien Priority—Code Section 364

Code Section 364 deals with post-petition financing. It provides that if a debtor is unable to secure financing elsewhere, and so long as the lender is provided with adequate protection, the bankruptcy court has the power to grant another party a lien equal to or senior to the lien of the prepetition lender. Adequate protection can be found if the lender is over-secured and there is a sufficient equity cushion, or if the lender is granted a lien in substitute collateral. The risk of having its liens primed by another party often causes a lender to agree to provide post-petition financing to preserve its senior priority position.

Avoidance of Liens—Code Section 547[52]

Code Section 547 allows a trustee[53] to avoid any transfer by the debtor, including the fixing of a lien:

1) which is made within 90 days of the filing of the petition (or within one year if the lienor is an insider);
2) which is made on account of an antecedent debt;
3) which is made while the debtor is insolvent (a rebuttable presumption); and
4) which allows the lienor to recover more than it would recover in a Chapter 7 liquidation if the transfer or the fixing of the lien had not occurred.

While the contemporaneous granting of liens in exchange for loan proceeds is protected from avoidance under Code Section 547(c)(1), as are purchase money liens perfected before or within 30 days of the date the debtor receives the collateral under Code Section 547(c)(3), liens granted to secure preexisting indebtedness are subject to avoidance.

One circumstance that surprises lenders is Code Section 547(c)(5),[54]

[52] Note Code Section 522 allows an individual debtor to avoid certain liens which impair his or her exemptions. Code Section 724 provides that a Chapter 7 trustee may avoid any lien which secures any fine, penalty or forfeiture, or any punitive, multiple or exemplary damages; not compensation for actual damages suffered by the claim holder which arise before the earlier of the order for relief or the appointment of the Chapter 7 trustee (*see* Code Section 726(a)(4)). While Code Section 724(b) provides that in a Chapter 7 proceeding, tax liens may be subordinated to other claims if all encumbered property is exhausted, there is no similar provision under Chapters 11, 12, or 13.

[53] "Trustee" includes the debtor in possession and, often, the unsecured creditors committee authorized by the bankruptcy court to bring the avoidance action on behalf of the estate.

[54] Code Section 547(c)(5) is actually cast as an exception to avoidance.

regarding floating liens in accounts receivable and inventory. If a lender has a prior perfected security interest in after-acquired receivables and inventory, and its aggregate collateral value is less than the aggregate indebtedness (causing the lender to be under-secured),[55] the attachment of its lien in accounts and inventory during the 90 days before the debtor's bankruptcy is avoidable if the attachment causes the position of the lender to improve over what it was on the 90th day before bankruptcy. In other words, if an under-secured lender's loan to collateral ratio improves during the 90 days preceding the bankruptcy, the liens on accounts and inventory attaching within the 90-day preference period are avoidable to the extent of such improvement. In practice, a lender that continues to advance funds to a debtor prior to a bankruptcy filing likely will not have improved its position, while a lender that cuts off funding in the pre-bankruptcy period may have done so.

Avoidance of Liens—Code Section 548 and the Uniform Fraudulent Transfer Act[56]

Code Section 548 and the Uniform Fraudulent Transfer Act ("UFTA") enacted in most states[57] allow the trustee to avoid transfers, including the fixing of liens, if the transfers are made for less than reasonably equivalent value and: (1) occur while the debtor was insolvent, or the transfers cause the debtor to become insolvent; (2) were made while the debtor was engaged in business with unreasonably small capital; or (3) were made when the debtor incurred or intended to incur debts beyond the debtor's ability to pay such debts. Lenders that receive collateralized guaranties from subsidiaries (upstream guaranties) or brother/sister entities (cross-stream guaranties) of their borrower, which in turn receive no consideration for giving the guaranties, risk avoidance of the guaranties and the liens securing them as fraudulent transfers if the liens are perfected while the affiliate guarantors are insolvent or are caused to become insolvent by the guaranties.[58]

Avoidance of Exercise of Setoffs—Code Section 553

Code Section 506 provides that a party that has a right to set off mutual

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[55] If the lender is over secured, the attachment of its lien to accounts and inventory within the 90 days preceding the bankruptcy will not result in the lender receiving more than it would have received in a Chapter 7 liquidation and, therefore, the lender will not have received a preference—making Code Section 547(c)(5) irrelevant.

[56] Trustees may apply the provisions of the Uniform Fraudulent Transfer Act pursuant to Code Section 544.

[57] Several states, such as New York, are governed by the Uniform Fraudulent Conveyance Act, the predecessor to the UFTA.

[58] A leading case on the subject is *Senior Transeastern Lenders v. Official Comm. of Unsecured Creditors (In re TOUSA, Inc.),* 680 F.3d 1298 (11th Cir. 2012).

debts under applicable law has a secured claim to the extent of such right. However, an under-secured lender's exercise of that right against funds the debtor has on deposit, for example, during the 90 days preceding the bankruptcy proceeding could result in the avoidance of the setoff and repayment of the amount set off to the bankruptcy estate. Similar to the analysis done in connection with Code Section 547(c)(5), if the setoff causes a reduction in the lender's aggregate loan-to-collateral exposure, or "insufficiency," as compared to the insufficiency that existed on the later of 90 days prior to the filing of the petition or the first day there exists an insufficiency, the lender can be forced to disgorge the amount set off. Note that unlike avoidable preferences, there is no requirement that the debtor be insolvent for a qualifying setoff to be recovered. Lenders confronted with a customer's imminent bankruptcy should carefully assess the risks of setting off against funds on deposit, rather than perhaps placing an administrative freeze on the account and thus preserving the secured claim in the bankruptcy proceeding.[59]

Subordinating a Secured Lender's Claim—Code Section 510(b)

Where a lender has engaged in inequitable conduct, Code Section 510(b) allows the bankruptcy court to reprioritize, or "subordinate," a claimant's claim to other claims in the bankruptcy case. While courts use this power sparingly, where the lender's conduct warrants it, for example by improperly dominating a debtor, they will exercise this power to equitably reorder the legal priorities of parties.[60] A lender involved in a work out with its borrower should carefully plan its strategy to avoid overreaching and thereby risk an attempt by the debtor or creditors committee to equitably subordinate its claim in a subsequent bankruptcy proceeding.

Recharacterization of an Insider Lender's Debt—Code Section 105

Where an insider equity holder makes loans to an undercapitalized entity that subsequently files bankruptcy, there is a significant risk that the debtor or the creditors committee will ask the bankruptcy court to use its equitable powers under Code Section 105 to recharacterize the debt as equity.[61] If the attempt is successful, the equity holder's secured claim and lien will be treated as equity and be subordinated in priority and payment to all other claims in the bankruptcy case. This is particularly problematic for business owners of closely

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[59] *See Citizens Bank of Md. v. Strumpf,* 516 U.S. 16 (1995), holding that an administrative freeze is not a setoff.

[60] *See In re Sentinel Mgmt. Grp., Inc.,* 728 F.3d 660 (7th Cir. 2013).

[61] *See Official Comm. of Unsecured Creditors v. Hancock Park Capital II, L.P. (In re Fitness Holdings Int'l, Inc.),* 714 F.3d 1141(9th Cir. 2013).

held distressed companies in workouts with their bank lenders, which may have no source of funding other than loans from their owners. The owner is faced with a Hobson's choice—allow the debtor to fail or make loans that could be recharacterized in a subsequent bankruptcy proceeding.

Substituting Collateral—Code Section 1129

Code Section 1129(b) permits a debtor to confirm a plan of reorganization over the objection of a secured creditor ("crammed down,") if certain conditions are met. The debtor can provide that the lender will retain its lien and receive a note with stream of payments having a present value equal to its interest in the collateral; the collateral can be sold free and clear with the lender's liens attaching to the proceeds of the sale; or the debtor can give the lender the "indubitable equivalent" of the lender's claims. A recent Seventh Circuit Court of Appeals case held that a debtor's attempt to substitute an under-secured creditor's lien on real property for a lien on treasury bonds was not the indubitable equivalent of a lien on real property. The court held that in the event of default, the lender would be able to immediately foreclose on the property, whereas if the market for the bond dropped, the lender would have to wait for the term of the bond to be paid. This precluded the offered bond from being the indubitable equivalent of the real estate.[62]

However, the Seventh Circuit also said that substituting collateral would be appropriate in a cram-down context if the creditor was over secured and the substituted property had sufficient value so as not to put the creditor at risk of becoming under secured in the future. The court went on to say that substitution of collateral may also be appropriate when the creditor is under secured, provided that the substituted collateral is more valuable and no more volatile than the creditor's current collateral.[63] The Fifth Circuit Court of Appeals affirmed confirmation of a plan pursuant to which promissory notes secured by 21 separate lots were given to the lender in exchange for a lien on a 200 acre parcel.[64] While the debtor's burden of showing that substituted collateral is the indubitable equivalent of the lender's prepetition collateral is high, where that showing can be made, the lender may find itself with a different deal than the one it contracted for.

OTHER ISSUES IMPACTING SECURED CREDITORS

There are certain statutes or circumstances applicable because of a borrower's

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[62] *In re River East Plaza, LLC,* 669 F.3d 826 (7th Cir. 2012).

[63] *Id.* at 831.

[64] *See B.M. Brite v. Sun Country Dev., Inc. (In re Sun Country Dev., Inc.),* 764 F.2d 406 (5th Cir. 1985).

conduct that may put a secured creditor's lien position in jeopardy. Cautious lenders should take note of these possibilities when making their credit decisions and when monitoring their borrower's ongoing operations to ensure that what they thought was a solid lien position does not become an illusion.

Liens in Hot Goods and the Fair Labor Standards Act

Under the Fair Labor Standards Act of 1938 ("FLSA"),[65] the Department of Labor can seek an order preventing the interstate shipment of goods produced in violation of minimum wage and overtime requirements (or which were produced in an establishment that violated child labor laws in the last 30 days)—known as "hot goods." Hot goods can include both manufactured products and agricultural goods shipped in interstate commerce. The U.S. Supreme Court has specifically held that secured creditors can be prevented from selling collateral acquired from a borrower that produced them in violation of the FLSA.[66] In doing so, the Court rejected that lender's argument that "innocent" foreclosing secured creditors that were not aware of or party to violations should not be subject to the act.[67] The Court said that the sweep of the statute, which applies to "any person" rather than "any employer," evidenced Congress's intention that the FLSA be broadly read.[68] Moreover, allowing foreclosing lenders to sell goods produced in violation of the FLSA would permit the lenders to unfairly compete with sellers whose goods were produced in accordance with the statute.[69] Lenders to borrowers that sell goods interstate, especially in the garment and agricultural industries, should protect their collateral position through appropriate loan covenants and periodic monitoring of their borrowers, such as through field audits, to ensure that the protections they have contracted for do not evaporate.

RICO and the Federal Forfeiture Statute

The Racketeer Influenced and Corrupt Organizations Act ("RICO")[70] and the companion Federal Forfeiture statute[71] provide for the forfeiture of property that constitutes the proceeds of criminal activity. On the positive side for lenders, the statute provides that third parties, including secured creditors,

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[65] *See* 29 U.S.C. §§ 201–219.

[66] *See Citicorp Indus. Credit, Inc. v. Brock,* 483 U.S. 27 (1987).

[67] *Id.* at 34.

[68] *Id.*

[69] *Id.* at 36–38.

[70] *See* 18 U.S.C. §§ 1961–1968.

[71] *See* 21 U.S.C. § 853.

have the ability to assert their rights in the property subject to forfeiture.[72] Recently, the Sixth Circuit Court of Appeals held that an unknowing lender to a borrower who defrauded dozens of lending institutions was a "bona fide purchaser for value" under the forfeiture statute and was entitled to retain the $700,000 deposit constituting its collateral.[73] However, a lender that is unable to demonstrate bona fide purchaser status would find its collateral at risk, highlighting the importance of the maxim "know thy borrower," and then acting prudently.

Garnishments vs. Secured Deposit Accounts

Finally, lenders with liens in deposit accounts, but which have not declared their borrower's loan to be in default, have lost priority disputes with garnishing creditors. Courts in Florida[74] and Illinois[75] have held that a lender's right to look to its collateral was only triggered by default, and because there was no default, the lender could not prevent a garnishing creditor from exercising its rights and taking the funds on deposit. These cases highlight the importance of carefully drafting forbearance agreements in workout situations to provide, where possible, that the defaults continue and the lender is forbearing from exercising its rights, rather than waiving defaults that have occurred.

CONCLUSION

As the foregoing demonstrates, there are plenty of potential issues to keep lenders up at night, even if they properly documented their loan at the outset of the lending relationship. However, if their loan agreements are carefully crafted to include the appropriate covenants and reserves, they perform periodic UCC searches and they monitor their borrowers and their borrower's activities, they should be able to sleep a little easier.

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[72] *Id.* at § 853(n).

[73] *See United States v. Huntington Nat'l Bank,* 682 F.3d 429 (6th Cir. 2012).

[74] *See Am, Home Assurance Co. v. Weaver Aggregate Transp., Inc.,* 84 F. Supp. 3d 1314 (M.D. Fla. 2015).

[75] *See One CW LLC v. Cartridge World N. Am. LLC,* 661 F. Supp. 2d 931 (N.D. Ill. 2009) and *S.E.I.U. Local No. 4 Pension Fund v. Pinnacle Health Care of Berwyn LLC,* 560 F. Supp. 2d 647 (N.D. Ill. 2008).