

**SO YOU THOUGHT YOU HAD A SENIOR LIEN?  
LOSING PRIORITY UNDER WISCONSIN AND FEDERAL LAW  
(and Other Lender Nightmares)**

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# Introduction

- Lenders base their credit decisions on their assessment of the likelihood that the loans will be repaid
- Prudent lenders take all necessary action to ensure that the liens taken on the debtor's collateral are properly perfected and senior to any other liens encumbering the collateral
- However, unless a lender is diligent in monitoring its debtor and the collateral, competing liens may arise that take priority over the lender's lien, jeopardizing the lender's ultimate repayment
- These threats can occur both inside and outside of a bankruptcy proceeding

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## Lien Disruptions Outside of Bankruptcy— Purchase Money Security Interests

- PMSIs prime existing liens in noninventory and in inventory
  - In goods other than inventory, the lien becomes senior to existing liens if it is perfected within 20 days of the date the debtor receives possession of the goods (Wis. Stat. § 409.324(1))
  - In inventory, the lien becomes senior if:
    - The lien is perfected when the debtor receives possession of the goods;
    - The PMSI lender sends authenticated notice to the competing lender;

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## Purchase Money Security Interests (cont.)

- The holder of the conflicting security interest receives the notice within five years of the date the debtor takes possession of the inventory; and
- The notice says that the PMSI holder intends to take a PMSI and describes the inventory (Wis. Stat. § 409.324(2))
- Commercial lenders usually protect themselves with covenants and periodic UCC searches; however, if nonbank lenders are not diligent, they could find their lien position eroded

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## 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 (Wis. Stat. § 70.01)
- When levied, the taxes become a lien on property effective as of January 1 of the year in which they are levied which is superior to all other liens, even preexisting liens (Wis. Stat. § 70.01)
- Most counties are uniform in enforcing liens on real property
- Enforcement of personal property liens is decidedly not uniform
- Milwaukee County has generally not enforced personal property liens while other counties, such as Sheboygan County, have been quite diligent

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## Federal and State Income Tax Liens

- Federal income tax liens on personal property are filed with the Department of Financial Institutions (Wis. Stat. § 779.97(2)(c)(1))
- Federal liens on real property are filed with the county register of deeds (Wis. Stat. § 779.97(2)(b))
- Wisconsin Department of Revenue Tax Warrants are filed with the clerk of courts of the county in which the property subject to the lien is located (Wis. Stat. § 71.91(5)(ar))
- The liens are subordinate in priority to existing liens of record perfected prior to the filing of the federal or state lien for income taxes

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## Federal and State Income Tax Liens (cont.)

- Under both the Internal Revenue Code (26 U.S.C. § 6323) and the UCC (Wis. Stat. § 409.323(2)), the preexisting secured lender retains priority only for advances made without knowledge of the tax lien and within 45 days after the filing of the tax lien
- Advances made more than 45 days after the filing of the tax lien retain their priority only if they are made without knowledge of the tax lien or made pursuant to a commitment to lend entered into without knowledge of the tax lien
- A lender should regularly check for newly filed tax liens to prevent unwelcome surprises

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## Construction Liens

- Construction liens, which arise from the first visible commencement of work, protect those that furnish goods and services in connection with the improvement of real estate (Wis. Stat. § 779.01(4))
- Construction liens must be filed with the circuit court of the county in which the real estate is located and within six months of the date goods or services are provided (Wis. Stat. § 779.06)
- Construction liens are senior to any mortgage recorded subsequent to the visible commencement of work, provided that the lien claimant did not have actual knowledge of the mortgage (Wis. Stat. § 779.01(4))

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## Construction Liens (cont.)

- An important exception to the priority rule exists with respect to 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 (Wis. Stat. § 706.11)
- Note that other lenders, such as private equity funds, venture capital funds, finance companies, non-bank asset-based lenders and insiders of the debtor, do not share this protection and will be primed by a construction lien that may be filed long after the mortgage is recorded

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## Wisconsin Wage Liens

- Chapter 109 of the Wisconsin Statutes gives employees a lien for unpaid wages and benefits that can be enforced by either the employee or the Wisconsin Department of Workforce Development ("DWD") on the employee's behalf
- In addition, employers with 50 or more full-time employees (excluding officers, directors and commissioned sales agents, among others) are obligated to give a 60-day plant closing notice if a business closes or a mass layoff occurs
- The DWD will assert a lien for the number of days less than 60 that a notice is not given

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## Wisconsin Wage Liens (cont.)

- The wage lien takes effect when it is filed with the clerk of the circuit court in which services were performed (Wis. Stat. § 109.09)
- The wage lien is senior to all other liens, but is capped at \$3,000 per employee with respect to prior liens of "commercial lending institutions" (Wis. Stat. § 109.09)
- "Commercial lending institutions" are institutions that provide commercial loans in Wisconsin (Wis. Stat. §§ 234.01(5k); 69.30(1)(b))
- There is no cap protecting the liens of lenders other than commercial lending institutions, such as insiders of the employer or private equity funds or venture capital funds not in the business of making loans in Wisconsin

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## Theft by Contractor

- Funds paid to a prime contractor or subcontractor by the owner of real property become a trust fund in the hands of the prime contractor or subcontractor, but not in the hands of any other party, for the benefit of suppliers, materialmen or laborers who provide goods or services related to the improvement of the real property (Wis. Stat. § 779.02(5))
- It is clear that a lender that receives and applies payments from a prime contractor or subcontractor for a loan secured by accounts receivable will not have to return the money pursuant to this section (*Schneider Fuel & Supply Co. v. W. Allis State Bank*, 70 Wis. 2d 1041, 236 N.W. 2d 266 (1975))

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## Theft by Contactor (cont.)

- However, a lender that has not applied the accounts receivable (*Wis. Dairies Coop. v. Citizens Bank & Tr.*, 160 Wis. 2d 758, 467 N.W. 2d 124 (1991)) or that has a right of setoff against its borrower/depositor that has not been exercised (*Kraemer Bros., Inc. v. Pulaski State Bank*, 138 Wis. 2d 395, 406 N.W. 2d 379 (1987)) will be subject to the trust fund rights of materialmen and suppliers, even if the construction lien claimants fail to perfect their respective lien rights

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## Wisconsin Statutory Liens

- Wisconsin has a variety of statutory liens, some of which are possessory
- Wisconsin's UCC accords them priority over preexisting security interests in goods unless the statute provides otherwise (Wis. Stat. § 409.333(2))
  - 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 weight, and a senior lien for work performed on boats up to \$1,200 (Wis. Stat. 779.41)
  - Motor carriers for towing, hotels, livery stables, garages, marinas and pastures are entitled to senior possessory liens between \$100 and \$1,500

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## Wisconsin Statutory Liens (cont.)

- Plastic fabricators have a lien that is accorded no priority for tooling in their possession (Wis. Stat. § 779.47)
- Cooks, jewelers, animal breeders, brokers and hospitals are also entitled to various lien rights (Wis. Stat., Chapter 779)
- However, loggers, lumber mills and miners have nonpossessory liens on goods for services provided, which are senior to all other liens and encumbrances, and which are not limited in amount (Wis. Stat. §§ 779.18; 779.35)

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## Common Law Bailee's Lien

- Parties that are in possession of another's goods that they have processed or enhanced may claim a common law bailee's lien
- The lien is broader than statutory liens because the entire money value of work performed may be asserted against that portion of the lot remaining in the bailee's possession (*Moynihan & Assocs., Inc. v. Hanisch*, 56 Wis. 2d 185, 201 N.W. 2d 534 (1972))
- Where the lien is covered by a statutory lien, the Chapter 779 dollar cap applies
- However, where the lien is not covered, the priming lien will be unlimited as to amount (Wis. Stat. § 409.333(1)(b))

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## Landlord's Liens

- Warehousemen have a lien on the bailor's goods covered by a warehouse receipt or storage agreement for storage, labor, insurance, transportation and related charges (Wis. Stat. § 407.209)
- Unless the landlord is a bona fide pledgee, the landlord's lien would not take precedence over a security interest holder
- However, where the landlord stores the goods with the acquiescence of the secured creditor, and where the warehouse lien is listed in the credit agreement as a permitted lien, courts will find that the landlord's lien will prime the lien of the secured party )*In re Sharon Steel Corp.*, 176 B.R. 384 (Bankr. W. D. Pa. 1995))

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## ERISA Liens

- Two types of liens arise in favor of the Pension Benefit Guaranty Corporation ("PBGC") under the Internal Revenue Code ("IRC") and the Employee Retirement Income Security Act of 1974 ("ERISA")
- The first arises when a company fails to make required pension plan contributions in excess of \$1 million (26 U.S.C. § 430(k))
- The second arises when an underfunded pension plan is terminated and has no minimum threshold (29 U.S.C. § 1368)
- However, the lien is limited to the lesser of (1) the liability, or (2) 30% of the collective net worth of the plan sponsor and members of any controlled group

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## ERISA Liens (cont.)

- Both liens are perfected in the same manner as federal tax liens. 26 U.S.C. § 6633
- Like federal tax liens, the prior perfected secured party retains its priority only for advances made within 45 days of the filing of the ERISA lien, provided the lender did not have actual knowledge of the ERISA lien
- However, both types of liens 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
- Unsuspecting lenders may find their collateral encumbered (and, on the 46th day, primed) by liens arising not against their borrower, but against its affiliates

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## PSA and PACA Trusts

- The Packers and Stockyards Act ("PSA") protects unpaid qualified sellers of livestock and poultry by the creation of a trust (7 U.S.C. § 181-229(c))
- The Perishable Agricultural Commodities Act ("PACA") creates a trust in favor of unpaid sellers of fresh produce (7 U.S.C. §499a-b)
- A lender that receives payment from its debtor's accounts receivable may have the status of a bona fide purchaser and be able to retain the payment (*C.H. Robinson Co. v. Tr. Co. Bank, N.A.*, 952 F.2d 1311 (11th Cir. 1992))
- However, a lender with knowledge of the PSA/PACA trust will be forced to disgorge the payments received (*Nickey Gregory Co. v. AgriCap, LLC*, 597 F.3d 591 (4th Cir. 2010))

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## The Risks of Junior Liens

- Even if a competing creditor's lien is junior, the senior lienor's position may be adversely affected
- For example, in Wisconsin, a junior creditor can request that the court require a senior creditor to marshal its claim if:
  - There are two creditors of the same debtor;
  - Two funds belong to a common debtor;
  - Only one of the creditors has access to both funds; and
  - There is an absence of prejudice to the senior if marshaling is applied (*In re Wm. Pietsch Co.*, 200 B.R. 207 (Bankr. E.D. Wis. 1996); *Great Lakes Agri-Services LLC v. State Bank of Newberg* (*In re Enright*), 474 B.R. 854 (Bankr. E.D. Wis. 2012))

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## The Risks of Junior Liens (cont.)

- In a state court receivership proceeding under Wisconsin Statutes, Chapter 128, if the junior lien is totally under secured, the receiver can request that the court allow a liquidator's sale to sell the assets free and clear of liens (Wis. Stat. § 128.25(6)(c))
- However, if there is collateral covering the junior lienor's claim, the receiver will be unable to sell the senior creditor's collateral without the junior creditor's consent (*Wis. Brick & Block Corp. v. Vogel*, 54 Wis.2d 321, 195 N.W.2d 664(1972); *BNP Paribas v. Olsen's Mill, Inc.*, 335 Wis.2d 427, 709 N.W.2d 792 (2011))

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## The Risks of Junior Liens (cont.)

- In a federal bankruptcy proceeding, the junior lienor may seek adequate protection, attempt to block confirmation of a plan of reorganization, or otherwise take positions contrary to the senior lienor
- To sell assets under Code section 363, the debtor must comply with section 363(f), which provides that a sale cannot be done unless:
  - Applicable nonbankruptcy law permits the sale;
  - The junior lienor consents;
  - The sale price is sufficient to pay the junior claim in full;
  - The junior interest is subject to a bona fide dispute; or
  - The junior lienor could be compelled in a legal or equitable proceeding to accept satisfaction of the interest
- Compare *Clear Channel Comm. v. Knupfer (In re PW, LLC)*, 391 B.R. 25 (BAP 9th Cir. 2016), with *In re Jolan, Inc.*, 403 B.R. 866 (Bankr. W.D. Wash. 2009)

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## The Effect of Bankruptcy on Existing Liens

- The filing of a bankruptcy petition by a borrower may have an immediate and profound effect upon the extent and priority of a lender's liens
- Various sections of the Bankruptcy Code permit a debtor and other parties-in-interest to challenge, and perhaps adversely impact, a lender's priority position
- Because some of these effects are automatic, lenders should carefully assess the potential impact of a bankruptcy filing when engaging in workout negotiations with a distressed borrower

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## The Automatic Stay—Section 362

- Code section 362 precludes creditors from exercising their respective state law rights with respect to their collateral
- Unless a secured creditor is diligent and demands adequate protection, the debtor will be free to use collateral that may be declining in value because of such use without compensating the creditor
- Of particular importance is cash collateral; although, under Code Section 363(c)(2), the debtor may not use cash collateral without either the lender's consent or pursuant to court order, if a debtor dissipates cash collateral, the lender may find its position significantly eroded with little recourse

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## Limitation on Liens Post-Petition—Section 552

- Code section 552 limits prebankruptcy liens in after-acquired property to proceeds, products, offspring or rents of prepetition collateral notwithstanding the grant of liens in after-acquired property in the party's loan documents
- Debtors often grant post-petition liens to their prepetition lenders to secure the post-petition use of cash collateral or post-petition financing
- However, if there is an equity cushion (value in excess of debt), such liens may not be granted
- Additionally, a third party may be granted liens in the debtor's post-petition assets the lender would otherwise have had a right to

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## Limitation on Extent of Prepetition Liens—Section 506

- A prepetition lender's lien on the debtor's property is limited to the value of such property. If the property is worth less than the debt, the lender has a secured claim equal to the value of the collateral and an unsecured claim for the balance of the debt.
- If a lender is under secured, its rights to post-petition interest and costs, including reasonable attorneys' fees, are eliminated even though the loan documents provide for them
- The debtor may ask the court to value the secured creditor's collateral at various times during a case. For example, the collateral may be valued to determine whether the lender is entitled to adequate protection or how it may be treated in a plan of reorganization.

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## Changes in Lien Priority—Section 364

- Code section 364 deals with post-petition financing
- The section provides that if the debtor is unable to secure credit elsewhere, so long as the prepetition lender is adequately protected, the bankruptcy court has the power to grant a third party a lien equal to or senior to the lien of the prepetition
- Although the court must find the original lender is adequately protected if a priming lien is granted, the lender may be required to rely on collateral other than accounts receivable and inventory, which may be less liquid and may decline in value over time
- Because of this, prebankruptcy lenders often prefer to provide post-petition financing to protect their position

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## Avoidance of Liens—Section 547

- Code section 547 allows the estate to avoid any transfer by a debtor, including the fixing of a lien that:
  - Is made within 90 days of the filing of the petition (or within one year if the lienor is an insider);
  - Is made on account of an antecedent debt;
  - Is made while the debtor is insolvent; and
  - Allows the lienor to recover more than it would recover in a Chapter 7 liquidation had the fixing of the lien not occurred
- PMSIs perfected within 30 days of the date the debtor receives possession of the collateral and the contemporaneous granting of liens in exchange for loan proceeds are protected from avoidance; however, liens granted to secure preexisting debt are not

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## Avoidance of Liens—Section 547 (cont.)

- Code section 547(c)(5) deals with the avoidance of floating liens in accounts receivable and inventory
- If a lender is under secured (e.g., loan greater than collateral value) and has a lien in accounts receivable and inventory, and if the attachment of such lien in the 90 days prior to the bankruptcy causes the lender's position to improve (e.g., lessens the amount by which the loan is under secured), the liens attaching to accounts receivable and inventory is avoidable to the extent of such improvement
- This is a surprise to many lenders. Lenders that cut off funding are more likely to be subject to this provision than those that continue to fund a debtor.

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## Avoidance of Liens— Section 548 and the UFTA

- Code section 548 and the Uniform Fraudulent Transfer Act ("UFTA") allows the estate to avoid transfers, including the fixing of liens, if the transfers were made for less than reasonably equivalent value and:
  - Occur while the debtor is insolvent or the transfers cause the debtors to become insolvent;
  - Were made while the debtor was engaged in a business with unreasonably small capital; or
  - Were made when the debtor incurred or intended to incur debts beyond the debtor's ability to pay
- Lenders that take collateralized upstream or cross-stream guaranties from affiliates of their borrower for little or no consideration, and that cause the affiliate to become insolvent are at risk of having their lien avoided

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## Avoidance of Liens— Section 548 and the UFTA (cont.)

- Under Code section 548, only transfers made within two years prior to the petition date can be avoided
- However, under Code section 544, so long as there is an actual creditor (called a "golden creditor"), the trustee can avoid transfers utilizing applicable law, such as the UFTA
- Under the UFTA, transfers made within four years in most states and six years in a few others would be avoidable using Code section 544

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## Avoidance of Liens— Section 548 and the UFTA (cont.)

- Several recent cases have indicated that when the IRS is the golden creditor, the statute of limitations under the Internal Revenue Code is applicable (ten years from the date of assessment of the tax; 26 U.S.C. § 6502) rather than the UFTA statute of limitations (*In re Kaiser*, 525 B.R. 697 (Bankr. N.D. Ill. 2014); *In re Kipnis*, 555 B.R. 877 (Bankr. S.D. Fla. 2016))
- More importantly, while several cases suggest that where the IRS is the golden creditor the lookback period within which transactions can be challenged is also ten years (see *In re Polichuk*, 506 B.R. 405 (Bankr. E.D. Pa., 2014)), a number of commentators have suggested that a strict reading of the IRC suggests the statute of limitations in this case is unlimited

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## Avoidance of Liens— Section 548 and the UFTA (cont.)

- Lenders participating in leveraged buyouts ("LBOs") are also at risk
- Code section 546(e) provides that settlement payments (including payments in connection with the purchase of stock) made by or to a financial institution are not subject to avoidance
- Thus, where a bank is an escrow agent that disburses sale proceeds from the sale of stock in an LBO involving two private companies, a number of courts have held the LBO is insulated from fraudulent transfer attack

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## Avoidance of Liens— Section 548 and the UFTA (cont.)

- However, the Seventh Circuit Court of Appeals recently held that section 546(e) did not insulate an LBO from being attacked as a fraudulent transfer where the financial institution was a mere conduit that was not a principal in the transaction (*FTI Consulting, Inc. v. Merit Management Group, LP*, 830 F.3d 690 (7th Cir. 2016))
- This decision exacerbated an existing Federal Circuit Court split and there is a pending petition to the U.S. Supreme Court to resolve the issue (*Deutsche Bank Tr. Co. Ams. v. Robert R. McCormick Found.*; Doc. No. 16-317 (2016))

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## Avoidance of Lienor Setoffs—Section 553

- Code section 506 provides that a creditor with setoff rights is treated as a secured creditor for the purposes of the bankruptcy
- However, if a creditor exercises its setoff rights within the 90 days prior to the petition date, the amount set off may have to be disgorged
- Similar to section 547(c)(5), if the setoff causes an improvement in the creditor's position by causing the amount by which it is under secured to decrease as of the petition date, the setoff can be avoided
- Unlike avoidable preferences, there is no requirement that the debtor be insolvent

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## Recharacterization of an Insider Lender's Debt

- Where an insider loans money to an undercapitalized entity that subsequently files bankruptcy, there is a significant risk that the estate will ask the court to use its equitable power under Code section 105 to recharacterize the debt as equity
  - If recharacterized, the insider lender's debt and lien will be treated as equity and subordinated in priority to all other claims in the case
  - This is problematic for business owners of closely-held companies in workout with their lender that may have no other source of funding, or that may be induced by their lender to make the loan
- The owner must choose between making a loan that could be recharacterized (and go unpaid) or allowing his company to fail

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## Substituting Collateral —Section 1129

- Code section 1129 allows a debtor to confirm a plan of reorganization or liquidation if it provides that:
  - The secured creditor receives a note with a stream of payments equal to present value of its interest in the collateral;
  - The collateral is sold free and clear with the lender's liens attaching to the proceeds of sale; or
  - The secured creditor receives the "indubitable equivalent" of its claim

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## Substituting Collateral —Section 1129 (cont.)

- In a recent case, the Seventh Circuit held that substituting treasury bonds for a lien in real property was not the indubitable equivalent. In the event of default, the lender could foreclose its lien in the property, whereas if market for the bond dropped, the lender would have to wait for the bond to mature to be paid (*In re River East Plaza*, 669 F.3d 826 (7th Cir. 2012) )
- However, the court said substituting collateral would be appropriate if the creditor was over secured and the substituted property was of sufficient value
- The Fifth Circuit allowed a debtor to substitute a lien on 21 separate parcels for a lien on a single 200-acre parcel. *In re Sun Country Dev., Inc.*, 764 F.2d 406 (5th Cir. 1985). This was a different deal than the one the lender contracted for.

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## Other Lender Nightmares

- A number of other issues outside of a bankruptcy proceeding may impact a lender's collateral position
- These involve debtor conduct that may preclude a lender from realizing on its collateral
- A lender that fails to diligently monitor its borrower may find its position seriously eroded
- Finally, actions lenders have taken in an attempt to prevent their borrowers from seeking bankruptcy protection have been increasingly found to be unenforceable

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## Hot Goods and the FLSA

- The Fair Labor Standards Act ("FLSA"), 20 U.S.C. §§ 201-219, provides that the Department of Labor can seek an order preventing the interstate shipment of goods produced in violation of minimum wage and overtime requirements, or produced in violation of child labor laws in the last 30 days ("Hot Goods")
- Hot Goods can include both manufactured products and agricultural goods shipped in interstate commerce

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## Hot Goods and the FLSA (cont.)

- Lenders have asserted that if they are unaware of FLSA violations, they are innocent and their collateral should not be affected by violations
- However, the U.S. Supreme Court has held that the FLSA applies to "any person" rather than "any employer," and it would be unfair to allow Hot Goods to compete with goods produced in accordance with the law (*Citicorp Indus. Credit, Inc. v. Brock*, 483 U.S. 27 (1987))
- Thus, it appears that diligent monitoring of their borrowers and appropriate loan covenants should be employed to protect a lender's position

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## RICO and the Federal Forfeiture Statute

- The Racketeer Influenced and Corrupt Organizations Act ("RICO"), 18 U.S.C. §§ 1961-1968, and the companion Federal Forfeiture Statute, 21 U.S.C. § 853, provide for the forfeiture of property that constitutes the proceeds of criminal activity
- The statutes and the case law protects lenders that are able to demonstrate that they are "bona fide purchasers for value" in connection with the loans made from losing their collateral (*U.S. v. Huntington Bank*, 653 F.3d 429 (6th Cir. 2012))
- However, careless (or complicit) lenders who cannot demonstrate bona fide purchaser status may find their collateral confiscated

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## Garnishments v. Secured Deposit Accounts

- Lenders with liens in deposit accounts, but which have not declared a default, have lost priority in disputes with garnishing creditors (*Am. Home Assurance Co. v. Weaver Aggregate Transp., Inc.*, 84 F. Supp. 3d 1334 (M.D. Fla. 2015); *One CW LLC v. Cartridge World N. Am.*, 661 F. Supp. 2d 931 (N.D. Ill 2009); *S.E.I.U. local No. 4 Pen. Fund v. Pinnacle Health Care of Berwyn LLC*, 560 F. Supp. 2d 647 (N.D. Ill. 2016))
- A lender in a workout should carefully consider whether declaring a default and forbearing from exercising its rights is a better alternative to waiving the default that is often requested by debtors

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## The Demise of Golden Shares and Blocking Directors?

- Creative lenders in workouts seek ways to control their borrowers without risking lender liability
- One common device is to require the borrower to amend its organizational documents to issue a single share of equity, known as a "golden share," to its lender and require unanimous consent to file a bankruptcy proceeding
- This tactic, used frequently in Special Purpose Entities, was thought to be enforceable, while a contractual promise prohibiting a debtor from filing a petition was not
- Two recent cases cast doubt on the enforceability of such provisions

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## The Demise of Golden Shares and Blocking Directors? (cont.)

- In the first case, *In re Lake Mich. Beach Pottawattamie Resort LLC*, 547 B.R. 899 (Bankr. N.D. Ill. 2016), the debtor and its lender entered into a forbearance agreement that required the issuance of a golden share to the lender, and the LLC agreement to be amended to require unanimous consent of the unit holders to file a bankruptcy petition
- The amendment also provided that, as a member, the lender had no obligation to invest capital and had no duty to consider any interests other than its own, including the interests of the company
- The debtor defaulted and, on the eve of a foreclosure sale, filed a Chapter 11 petition without the lender's consent
- The lender moved to dismiss the filing as unauthorized

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## The Demise of Golden Shares and Blocking Directors? (cont.)

- The court held that while contractual provisions prohibiting a debtor from filing bankruptcy are not enforceable, provisions in organizational documents for entities created under state law may be enforceable provided that other state law requirements are met
- However, Michigan's LLC law, which was applicable here, required the members to act in accordance with their fiduciary duties, and to take action that was in the best interests of the company
- Because the LLC amendment provided that the lender had no duty to the company, it was void under Michigan and bankruptcy law

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## The Demise of Golden Shares and Blocking Directors? (cont.)

- The second case, *In re Intervention Energy Holdings, LLC*, 553 B.R. 258 (Bankr. D. Del. 2016), had very similar facts. Two LLCs entered into a forbearance agreement with their lender that required the lender to receive a golden share and required unanimous consent for a bankruptcy filing.
- After a default, the debtors filed Chapter 11 petitions without the lender's consent
- As in *Lake Michigan Beach*, the lender filed a motion to dismiss

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## The Demise of Golden Shares and Blocking Directors? (cont.)

- In a much more restrictive holding, the *Intervention Energy Holdings* court found that the Bankruptcy Code preempts the private right to contract around its provisions
- Rejecting the lender's claim that finding the blocking directors' provision to be unenforceable would vitiate the will of the state legislature, the court held that states cannot deny an individual's (including an entity's) right to seek bankruptcy relief
- The court found that even if the provision complied with state law, it was void as against federal public policy

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## Questions?



## THANK YOU!

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