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LEGAL lines

Negative Effects of Hidden Liens:
How to Identify, Avoid and Protect Against Pitfalls

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Attorneys Jeffrey Wurst and Jonathan Bodner discuss how lenders can identify and avoid lending into problem situations that involve hidden liens. The authors note that these liens come in many varieties, including tax, agricultural, materialmen and construction related.

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Lenders need to take comfort that they have obtained a first priority security interest in the collateral upon which they are relying in making loans to their borrowers. Hidden liens can sneak up and undermine what was otherwise a secure loan. The goal of this article is to sensitize lenders to certain types of hidden liens with the hope of helping them avoid falling into the traps caused by innocently lending into problem situations and being primed by a hidden lien.

Hidden liens come in many varieties, including tax liens, agricultural liens, materialmen and construction related liens. Lenders may, in some cases, protect themselves against these pitfalls at the onset of the loan. In other cases, lenders need to regularly monitor for potential priming liens and promptly take action should a problem situation arise.

The potential hidden liens of which most lenders remain aware and protected against are IRS tax liens. Receivable lenders and factors are generally well trained concerning this potential lien and regularly run tax lien searches to avoid being caught in a problem. When the IRS files a tax lien against a borrower, the IRS will prime the secured lender's rights to accounts receivable upon the earlier of 45 days following the filing of the lien or the lender obtaining actual notice of the tax lien.[1] When a tax lien is discovered, the lender or factor must cease lending against or purchasing newly created accounts until an arrangement is entered into with the taxing authority. Subordination arrangements are regularly obtained on terms acceptable to the IRS, typically with the requirement that a portion of the advances made against the post-lien accounts be paid directly to the IRS as a condition for its subordination to the lender or factor.

Construction related liens can cause havoc to the unwary lender. Most states have created statutory protections for the benefit of those who provide materials or services used in the construction or improvement of real property. Lenders, while typically aware of the risk of these priming liens, still often neglect to recognize that the accounts they are lending against may be subject to these types of priming liens, some of which come about by way of trusts or constructive trusts.

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The New York lien law is a good example of how this can come about but also provides a simple solution where lenders can avoid this risk. This lien law creates a trust for the benefit of subcontractors and materialmen to assure that the funds paid on the project are used to pay these obligations. When a lender receives payments on projects that include the improvement of real property, and applies those funds in reduction of

1 IRS Code Section 6323(c)(2)(B).

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the loan — even a revolving loan where funds are readvanced — those funds may be deemed trust funds and the lender may be responsible to satisfy the claims of unpaid subcontractors and materialmen.

In New York, that risk can be eliminated if the lender files a notice of lending with the appropriate filing office. Too often, however, lenders fail to recognize that the accounts they are lending against actually arise from the improvement of real property. The lesson can be a costly one. Unpaid real property taxes will typically prime a mortgage. Residential lenders generally escrow for taxes but commercial real estate lenders do not. When a commercial mortgage falls into default it is not uncommon for a lender to discover that taxes have gone unpaid and will need to be satisfied before the lender can recover on its collateral.

Risks can also be mitigated in the context of hidden liens that arise by statutory trusts. The Packers and Stockyards Act (PSA) established a trust arising under federal law involving meat and poultry. The Perishable Agricultural Commodities Act (PACA) established a similar trust involving produce. However, prudent lenders can take steps, including requiring the posting of bonds, letters of credit or tri-party agreements, and closely scrutinizing borrowers, to avoid being primed by these hidden liens. In any event, lenders need to maintain reserves to cover any obligations that may arise under PSA or PACA, and must carefully monitor the borrower's payables to PSA and PACA creditors.

Lenders must also be aware that claims of hidden liens arising under lesser known theories may be asserted by savvy creditors' rights attorneys, and that less common hidden lien issues arise from time to time.

In *In re Alco Stores, Inc.*, the U.S. Bankruptcy Court for the Northern District of Texas was recently faced with determining whether 'state money transmitter statutes' imposed a hidden lien or statutory trust similar to the PSA or PACA to impose a "floating trust" on *all* of a debtor's assets so as not to require "tracing" in bankruptcy (generally, requires a trust beneficiary to identify and trace its alleged trust funds). In *Alco Stores*, Alco, a general merchandising retailer operating 198 retail stores in 23 states, sold, among other things, Store Value Cards (SVCs) for consumers to select off display racks, request the retail cashier to load the SVCs with specific monetary amounts, and then later redeem the SVCs at the participating retail establishments. The SVC funds were comingled in Alco's general cash management system, and ultimately made their way to Alco's master account. Alco's pre-petition date secured lender, which held a lien on all of Alco's assets, would sweep essentially all funds from Alco's master account on a daily basis. Alco sold the SVCs to its customers, did not remit those payments to the SVC distributor, and was indebted more than $800,000 as of Alco's bankruptcy petition date.

Alco's indebtedness to its pre-petition date secured lender exceeded $104 million as of the petition date. Upon the bankruptcy filing, the SVC distributor asserted that it held a floating lien pursuant to "state money transmitter statutes," which provided for a trust on the SVC sales proceeds, as well as assets commingled therewith. The SVC distributor analogized the state money transmitter statutes to the PSA and PACA and asserted that a "floating trust" applied to all assets of Alco, its trust claims attached to *any* asset of Alco, and "tracing" was not required in bankruptcy. As

Lenders should proactively seek ways to educate themselves on less common hidden lien theories arising under federal law or from state to state. Even in less common hidden lien situations, lenders can likely mitigate risk by traditional methods such as posting of bonds, letters of credit, tri-party agreements, as well as borrower monitoring.

the secured lender swept all cash on a daily basis and there were no comingled funds remaining in Alco's possession as of the petition date, the SVC distributor looked to impose its trust claims upon the proceeds from the liquidation of Alco's assets in bankruptcy.

The bankruptcy court held that, assuming state money transmitter statutes apply to SVCs, the statutes create a trust on proceeds from SVC sales and assets comingled therewith, but do not go as far as the PSA or PACA whereby the tracing requirement may be dispensed within bankruptcy, because, among other things, there was not a clear policy reason articulated by the legislatures that would provide for dispensing with a need for tracing for these statutes. As such, the court held that the SVC distributor's trust claims did not attach to the proceeds from Alco's bankruptcy sales and the SVC distributor had an unsecured claim to the liquidation sale proceeds.

Notably, had there been SVC funds commingled with other funds in Alco's possession as of the petition date, there likely may have been a very different result for the SVC distributor as to its claim against property which otherwise constituted collateral of the lender.

Alco is a great example of a less known hidden lien that can arise under state money transmitter statutes, and there are several lessons commercial lenders can take away from Alco. First, lenders should proactively seek ways to educate themselves on less common hidden lien theories arising under federal law or from state to state. Second, even in less common hidden lien situations, lenders can likely mitigate risk by traditional methods such as posting of bonds, letters of credit, tri-party agreements, as well as borrower monitoring.

In addition to federal liens, there are numerous state specific hidden liens. It is strongly recommended that lenders seek out and follow the advice of professionals who are knowledgeable in these issues when making loans into industries subject to hidden liens. Often, the education is too late in coming and results in a very high cost. abfj

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